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IMPACT OF CORPORATE TAKEOVERS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

THE EFFECT OF MERGERS ON MANAGEMENT PRACTICES, COST, AVAILABILITY OF CREDIT, AND THE LONG-TERM VIABILITY OF AMERICAN INDUSTRY

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IMPACT OF CORPORATE TAKEOVERS

WEDNESDAY, APRIL 3, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met, at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Hecht, Cranston, Sasser, Reigle and Proxmire.

Also present: Senator Metzenbaum.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning. The Subcommittee on Securities today will begin the first of 2 scheduled days of hearings in what will be a series of hearings on the issue of corporate takeovers. The subject of corporate takeovers is of great interest today.

In 1984, there were approximately $135 billion in merger and acquisition activities. No doubt it indicates that the recent merger and acquisition activity as measured by the number of reported transactions has been at a rate less than one-half that reported in the 1960's. The total value of merger and acquisition transactions has reached new heights. Of the 100 largest merger and acquisition transactions reported through the years end, over 65 occurred recently between 1981 and 1984 and less than 11 occurred prior to 1979.

Current records in terms of merger and acquisition stands at some $13 billion. Merger and acquisition activities of this magnitude mandates that we thoroughly examine the impact of these corporate practices.

These billions of dollars in mergers raise some immediate questions as to whether these mergers are in the best interest of the bidder and target shareholders, the bidder and the target employees and companies.

On a board of scale of public interest we must also consider the effect of such mergers on management practices, cost and availability of credit, and the long-term viability of American industry. In the end, we must balance these competing interests within the constraints imposed by a free market economy. The game of corporate takeovers is a high-stakes game for willing and unwilling participants alike. There is no question at this point that some of the offensive and defensive tactics have gotten out of hand. Whether or

not they have gotten so abusive as to have an adverse impact on capital formation is an issue which we must consider.

The legislative history of the Williams Act indicates that Congress intended to embrace a policy of neutrality, neither favoring the bidder nor the target. I feel strongly that we must conduct a thorough review of these issues before tipping that balance.

However, I question aloud whether broad Federal legislation which could result in the entrenchment of incumbent management is the answer to the problem that can be cured by State action or by corporate charter amendments. If State courts would fashion a more flexible business judgment rule, corporate management would be more accountable to their shareholders and there would be an effective mechanism to deal with some of the so-called abusive management practices.

It is my hope that at the conclusion of the 4 or 5 days of hearings on corporate takeovers we will all have a firmer grasp of these issues and a better sense of direction before we move by way of legislative initiative.

At this time we will take opening statements if my colleagues have any.

Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. Thank you very much, Mr. Chairman.

The debate on the public policy implications of hostile merger and acquisition activity on the U.S. economy, shareholders, management, and the public has intensified over the last several years. A reason frequently cited for this merger and acquisition activity is that with sustained inflation many corporate securities have become undervalued compared to the intrinsic value of the company's underlying assets. This fact, combined with persistently high-interest rates and the risk associated with new business ventures, may provide more incentive to purchase existing entities than to invest in new plants or new enterprises.

Others cite favorable tax and accounting laws that reduce or eliminate the cost of a large amount of debt needed to carry out acquisitions. Some experts believe that hostile takeovers should be addressed by neutralizing tax laws, by abolishing the deduction of interest payments on borrowed debt on highly leveraged acquisitions and restricting greenmail payments to corporate raiders.

Others would attempt to remedy abuses by providing more right to shareholders against defensive and potentially harmful management practices and would allow private rights of action and increased time periods for tender offers.

Notwithstanding the frenzied merger mania going on in the current economic environment that may be intensifying takeover bidding, a certain degree of merger and acquisition activity is to be expected. Mergers and acquisitions can provide financing for management and access to resources or markets which might not otherwise be obtainable or an opportunity to profit from better utilization of existing resources that may be inadequately managed by current management.

In addition, an entrepreneur who has developed a company may seek to sell it and shareholders may have an opportunity to receive a premium return on their investment.

On the other hand, merger and acquisition activity, in particular the battles involving disputes among various parties, give rise to issues that are of major concern to me, to the committee, and to the public such as, the concentration of power, economic efficiency, conflicts of interest, dissipation of corporate assets, diminution of shareholder returns, loss of jobs in communities, unproductive use of resources, and equity and fairness to the public. These are just a few of the many issues this subcommittee will attempt to address today and in the days that follow.

As the new ranking minority member of this subcommittee, this is our first hearing this year. I have an open mind on these problems and look forward to hearing your views and those of others. I do tend to the view that some changes in present laws are necessary to deal with the free-swinging takeovers that we have witnessed in recent times and years.

I have a second purpose today and that is to introduce one of the members of this panel. I think it's a very illustrious panel. I'm eager to hear your advice to us. Unfortunately, I will not be able to stay throughout the whole hearing because of another activity by another committee upon which I serve.

Among those appearing is one of your constituents, Mr. Chairman, Marty Lipton, who is an outstanding witness before us with very great knowledge on this subject and I'm eager to hear his views.

Another is a constituent of mine, Mr. Montgomery, and I'm delighted to welcome you to this committee and I look forward to hearing your views, as I do all the others.

My other purpose, however, today is to introduce Claude Brinegar to this committee. It was my pleasure to introduce him to this committee in 1973 when he was nominated by the President to serve as Secretary of Transportation, a job that he held with great distinction. He is a senior vice president and member of the executive committee and board of directors of Union Oil Co. Mr. Brinegar's business career started in 1953 when he joined Union Oil as an economic analyst. He held a series of positions in the area of economic planning and in 1965 was named vice president of economics and corporate planning. Later that same year he was appointed president of Union's newly acquired Pure Oil Division. In 1968, he became president of the Union '76 Division with responsibilities for Union's nationwide refining and marketing activities.

Then came his service in the Cabinet. While in the Cabinet, Mr. Brinegar served on the Domestic Council of the Economic Policy Board, the Energy Resources Council, as a member of the board of directors of Amtrak, and a member of the board of the U.S. Railway Association.

Mr. Brinegar resigned from the Cabinet in February 1975 to resume his business career. He was educated at Stanford University, another factor, among two more and many others that we share, where he received a B.A. degree in economics, an M.S. degree in statistics, and Ph.D. in economics research. At Stanford he was elected to Phi Beta Kappa and Sigma Chi. He is a member

of the board of directors of the American Petroleum Institute, Union National Institute for Economic Research of which he is chairman, the California Council for Environmental and Economic Balance, and the National Energy Foundation.

He reminded me this morning that we also share an interest in collecting first editions of Mark Twain.

Claude, it's a pleasure to welcome you here.

Senator D'AMATO. Senator Hecht, do you have an opening statement?

Senator HECHT. Thank you, Mr. Chairman. No statement.

Senator D'AMATO. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Mr. Chairman. I want to congratulate you on these hearings. I'm delighted to see them. You were absolutely right in your opening statement when you pointed out that there is a clash between public policy objectives. I feel somewhat ambivalent on this issue, as I'm sure all of us do. One of the freedoms we value most highly is the right to spend our own money and invest in what we want to invest in, and the right for capital to move freely into various institutions.

I can recall in 1938 at the Harvard Business School we had the White Motor Co. case. Now the White Motor Co. was a company that had an amazing situation in the depression. The cash value of their stock was about $20 a share roughly. The market price was $10 a share. Now what that meant was that you could buy that company, the entire company, and if you got absolutely nothing for their receivables, their inventory, their plant, their equipment and so forth, you could still double your investment just by taking the cash. That seemed to me like a great opportunity. I wanted to go to Wall Street and get to work right away. But obviously under those circumstances, there was a reason for it. And the reason was because the stockholders felt that the future of that company was pretty dim.

Now that seemed to me to be a very strong persuasive argument to let people move in and take over and liquidate a company that really wasn't necessary and let the free market work.

However, the market does not always behave the way the textbooks describe. In fact, I now believe the rising tide of hostile takeovers threaten the very foundations of our business system. In theory, hostile takeovers are supposed to improve efficiency by ousting inept corporate managers. In reality, they serve little purpose but to make millions for the professional raiders, their lawyers, and investment bankers. The fact is, that the corporations taken over show that the average return is something like 16 percent, which is much higher than the return earned by most corporations. In the process, takeovers undermine corporate productivity, wreak havoc in entire communities, and saddle well-managed companies with billions of dollars in excessive debt.

Contrary to the conventional wisdom, the evidence shows it is not the poorly managed companies that are victimized by the professional raiders.

Why aren't takeovers just another example of the free market at work as alleged by the Reagan administration? Because the stock market, by and large, does not reflect the true replacement value of U.S. corporations. As long as we continue to have $200 billion budget deficits, investors will continue to believe that real interest rates will remain abnormally high and thus shy away from the stock market and put their money in fixed income securities. As a result, the price of all stocks relative to replacement value has taken a nosedive. For example, in 1970, the average stock was priced at 115 percent of replacement value. By the end of the decade, that ratio declined to 65 percent, paving the way for the raider to work his corporate mischief.

One harmful effect of hostile takeovers is to divert the time and attention of corporate managers away from productive endeavors. The top managers of our foreign competitors spend most of their time figuring out how to produce better products and services. Our top managers are spending too much of their time playing financial mickey mouse games—either plotting or defending against hostile takeovers.

Another serious effect of hostile takeovers is that they lead to excessive debt structures. Why? Because the raider perceives that in the short run the target company can boost its per share earnings by leveraging to the hilt. But this simply prevents the company from undertaking the long-term investments needed to remain competitive in today's rapidly changing economy. Last year, $90 billion of equity was exchanged for debt. If this process continues, we could have a real disaster in the next economic downturn because of this excessive borrowing.

Many of the academic studies defending hostile takeovers are focused narrowly on what happens to the stockholders of a target company. Because the price of the stock almost always increases, these observers conclude that takeovers are beneficial. But the problem of hostile takeovers goes well beyond the welfare of stockholders. We all lose when productivity is impaired and our companies fail to perform well in international competition. Moreover, even the temporary, short-term gains of stockholders can turn into big losses if the excessive debt structure brought about by takeovers triggers a wave of corporate bankruptcies during the next recession.

And so the problem goes well beyond the expertise of the securities bar or the microeconomist. I am pleased to see we have a well chosen panel of witnesses who will give us their thoughts today. I hope that as we get deeper into this issue we can draw upon additional witnesses who have something to contribute.

Senator D'AMATO. Senator Sasser.

Senator SASSER. No opening statement, Mr. Chairman.

Senator D'AMATO. We are pleased to have our colleague, Senator Metzenbaum, join us today. Senator Metzenbaum, do you have an opening statement?

OPENING STATEMENT OF SENATOR METZENBAUM

Senator METZENBAUM. Thank you very much, Mr. Chairman. First let me state my appreciation to you for your courtesy in

asking me to sit with this distinguished committee and I particularly commend you for holding these hearings.

I think it is a matter of great urgency that the issue be dealt with because each day we learn of some new takeover attempt. We have seen corporate raiders resort to coercive and unfair tactics either to gain control over a target or extorted payments to withdraw their bids, the noted practice of greenmail. We have seen target management, often motivated by selfish desire to stay in power, employ aggressive defenses to thwart a hostile bidder, in some instances giving away the company's finest assets.

And often the victim of these abusive biddings as well as the defensive tactics are the shareholders, and particularly the small shareholder. The large shareholder, the institution, is in a position quite often to protect itself and to fend for itself, but the small shareholder doesn't know what's going on and by the time he or she wakes up to what's going on the ballgame is over and the horse is out of the barn.

It's clear to me that the time has come to amend the Williams Act and eliminate the loopholes exploited by tender offer practitioners. As a matter of fact, I don't fault the tender offer practitioners, nor do I particularly fault the corporate leadership in using defensive tactics. I fault ourselves if we make it possible for them to do that without giving first consideration to the shareholders and their rights.

Tender offers can be a healthy way to discipline lazy corporate managers and help shareholders realize the true value of their investment. In the main, that isn't the objective, I might point out, of those who are making the tender offers. But it does not necessarily follow that all tender offers are good for the shareholders and the economy. Indeed, it is a self-serving oversimplification to claim, as many corporate takeover specialists do, that only poorly managed companies need fear takeover. In fact, there's considerable evidence that some of our best-run companies are the most likely takeover candidates.

I must question a policy where the companies working hardest to meet the global economic challenges are replaced by larger, weaker, and less efficient conglomerates, who must justify their empire building by emphasizing short-run profit maximization over long-term industrial growth.

I will shortly introduce legislation that will deal with the new realities dominating the corporate tender offer arena. The legislation would prohibit front-end loaded, two-tiered offers. It would prohibit partial tender offers where a bidder seeks more than 21 percent of the target stock unless he or she tenders for all shares at the same price. It would restrict greenmail as proposed by the SEC. It would require tender offers to be open for 60 business days. It would prohibit targets once a tender offer is announced from making structural changes in the company such as selling the crown jewels or issuing poison pills without shareholder approval, and it would close the 10-day window.

It's fair to point out that there are a number of other bills. Senator Proxmire has introduced legislation and others have and I don't believe we stand in contradiction with each other. I think it's a matter of our working with the leadership of the business commu-

nity to see to it that we can fashion a legislative proposal that will be fair to all the shareholders, not impinge upon the free enterprise system as such, but certainly I think we can all agree that permitting these takeovers and greenmail episodes as well as the many other actions that have been taking place in recent weeks and months to continue without our attempting to resolve the issues in this committee where it properly belongs would indicate a failure on our part to meet our responsibilities.

The chairman knows that in the last session I was prepared to go to the floor with some amendments. I would hope that we not resolve the matter in that way, but that this committee can fashion a piece of legislation either mine or someone else's that will meet the challenge and that we not make it a matter of who can gain 51 votes on the floor of the U.S. Senate. I think it's a pressing problem. I think it's a matter of concern to the American economy and to the system as such, and I'm very happy to work with the chairman and grateful to him for his cooperation.

Senator D'AMATO. Let me ask our witnesses—first of all, let me express the thanks of this committee for all of you taking your time to be here. You have come many miles and left important engagements to share your knowledge and your insights with us. If it is possible to summarize your statements in 10 minutes, then we will have more of an opportunity to ask you some of the questions that I know my colleagues will have. So I would ask you to be mindful of the time limit and we'll begin hearing testimony from the left to the right.

Mr. Lipton needs no introduction to this panel from the business community. He's been involved in the corporate takeover area, both offensively and defensively, in more cases than most have been in a lifetime. We are delighted that you're here and look forward to your testimony.

STATEMENT OF MARTIN LIPTON, ESQ., SENIOR PARTNER, WACHTELL, LIPTON, ROSEN & KATZ, NEW YORK, NY

Mr. LIPTON. Thank you, Senator D'Amato.

DISASTROUS EFFECTS

During the past 3 years there has been sharp growth in highly leveraged takeovers by entrepreneurs who are not interested in operating the target companies, but seek the opportunity for profit through greenmail, bustup liquidation of the target or forcing a white knight transaction that usually also results in bustup liquidation of the target. These takeovers are not for the purpose of diversification, expansion, or growth. They are financial transactions for the profit of the takeover entrepreneurs. They do not create jobs. They do not add to the national wealth. They merely rearrange ownership interests by substituting lenders for shareholders and shift risk from equity owners to creditors. They place our banking system and credit markets in jeopardy. They restrict the ability of the affected businesses to grow and provide increased productivity and employment.

The President's Council of Economic Advisers and the Office of Management and Budget, as well as a large number of private

economists, argue that hostile takeovers move the assets of the targets into the hands of more efficient management and therefore are economically desirable. This often is correct with respect to soundly financed acquisitions by operating companies that are seeking to diversify or expand. Mergers by successful operating companies have been an integral part of our economic development. They should not be restricted. They improve the economy. But this is not true with respect to bustup liquidation takeovers by takeover entrepreneurs. They do not move assets into more efficient management. They move assets into hands that profit by reducing expenditures for research and development and capital improvements. After a highly leveraged takeover, a very high percentage of the revenues produced by the acquired assets must be diverted from research and development and capital investment to paying the debt incurred to acquire the assets.

The situation can be analogized to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertilize his land and does not protect his land by building fences, planting cover, and creating windbreaks. In the early years our farmer will maximize his return from the land. It is a very profitable short-term use. But inevitably it leads to a dust bowl and economic disaster.

A national policy favoring bustup takeovers is a policy that favors the present at the expense of the future. It is consistent with economic policies and political decisions that result in huge deficits in the national budget. Those deficits also benefit the present at the expense of the future. The reasoning of the Council of Economic Advisers and the Office of Management and Budget with respect to takeovers is apparently the same as that which results in the national deficits. These policies are not sound. Unfortunately, the future has no political constituency.

In addition, our accounting conventions and tax laws favor highly leveraged acquisitions over direct research and development and new product introduction expenditures and capital investments. The ability to defer, over periods as long as 40 years, the amortization of acquisition premiums makes takeovers more attractive from an accounting standpoint than those expenditures which must be charged against income immediately or over a relatively short period. The ability to deduct for tax purposes interest on debt, but not dividends on stock, makes high leverage more attractive than sound balance sheets. These are arbitrary tax and accounting policies which, although in effect for many years, have no fundamental justification. It is time that their serious adverse impact on the economy is recognized and corrected.

We have entered the era of the two-tier, front-end loaded, bootstrap, bustup, junk bond takeover. Day after day the takeover entrepreneurs are maximizing their returns at the expense of future generations that will not benefit from the research and development and capital investments that takeover entrepreneurs are forcing businesses to forego. The message is clear. If a company wants to avoid being taken over and busted up, it must sacrifice long-term growth and future profits. It must use the maximum amount of leverage and operate with the primary objective of short-term profitability. This may in the short run save it from the liquidator.

However, it will ultimately succumb to the advantages enjoyed by its foreign competitors. They are not hindered by outmoded tax laws and accounting conventions. They are not prey to takeover entrepreneurs and the institutional investment managers who encourage takeover entrepreneurs.

As the takeover entrepreneurs have grown more aggressive corporations are being forced to match them. We are faced with escalating offensive and defensive tactics. To meet the threat of the two-tier, front-end loaded, bootstrap, bustup, junk bond takeover, we have developed fair price charter amendments, fair value rights and staggered boards. The takeover entrepreneurs and their academic supporters call them shark repellents, poison pills, and management entrenchment. To us, they are only defensive missiles—never to be fired except in self-defense.

The bustup takeover and the extreme leverage that is being built into the structure of American business have created a pressing national problem. While different in form, what we face today is not different in substance from what happened in 1928 and 1929. Leverage produces great results on the way up, but no economy ever goes up in a straight line and high leverage inevitably produces a crash when an economy turns down.

I have proposed legislation to deal with part of the problem. The legislation I propose is a balanced approach to correcting the abuses of the takeover process. Its net effect is to curb takeover abuses and promote real shareholder democracy. At the same time, unlike some recent legislative proposals, it preserves the traditional role of the States in regulating corporations. However, my proposal is not an overall solution. That can be achieved only by correcting the accounting and tax policies that encourage highly leveraged speculative takeovers. As indicated by the opening statements of some of the Senators this morning, such legislation has been proposed and is now being studied. I believe that all of these proposals are deserving of careful consideration by this committee and the Congress. Thank you.

[The complete prepared statement follows:]

TESTIMONY OF

MARTIN LIPTON, ESQ.

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

APRIL 3, 1985

THE SHAREHOLDER PROTECTION AND ELIMINATION OF TAKEOVER ABUSES ACT OF 1985

INTRODUCTION

In light of the experience in the last session of Congress with H.R. 5693, 5694, 5695 and 5972, and S. 2754, 2782, 2783, 2784 and 2785 (including H.R. 5694 and S. 2783 that I drafted), I recommend a new legislative approach to protect shareholders and eliminate the abuses that have crept into the takeover process.

The new approach, called the Shareholder Protection and Elimination of Takeover Abuses Act of 1985, builds on my personal experience as counsel for both acquirors and target companies in takeover matters, service on the Securities and Exchange Commission Advisory Committee on Tender Offers and the testimony and comments submitted to Congressional committees in connection with pending bills.

The legislation I propose:

° Does not add new regulation, but primarily accomplishes its objectives through deregulation.

° Protects shareholders from takeover abuses by both takeover entrepreneurs and entrenched managements.

° Assures all shareholders of fair and equal treatment and ample time to make reasonable decisions as to their best alternatives in takeover situations.

° Eliminates the universally condemned practice of greenmail.

° Preserves shareholder democracy and gives the holders of common stock a really meaningful opportunity to use the corporate proxy machinery to prevent management entrenchment. A substantial shareholder will have the same right as, and equal opportunity with, management to urge the shareholders to change corporate policy or management.

° Does not deter or handicap takeover bids by companies that are prepared to make fair and equal offers to all shareholders and permits cash and securities tender offers to be made on an equal basis.

° Protects employees, customers, suppliers, pensioners and communities against the disasterous effects of bust-up takeovers.

° Does not in any way interfere with the traditional role of the states in corporate governance and leaves the business judgment rule to evolution in the state courts.

° Eliminates abusive front-end loaded two-tier tender offers and creeping open-market takeovers that were developed to give takeover entrepreneurs the upper hand, and thereby eliminates the need for takeover targets to resort to shark repellents, crown jewel options, pac-man defenses, issuance of blocking preferreds, poison pills, greenmail and other pejoratively named defenses developed to try to counterbalance such takeover tactics.

° Preserves the ability of corporations to raise venture capital, use innovative financing techniques, negotiate desirable mergers and acquisitions and have all the free market acquisition and financing flexibility they presently enjoy.

° Enables corporations to reduce their concern with abusive bust-up takeovers and devote greater time and resources to the long-term planning that is essential to the

preservation of the preeminent position of American industry in a worldwide economy.

° Creates an even playing field on which free market forces and the competitive skills of corporate managements can assure that our public corporations and national assets are managed by the best people and are devoted to the uses that are most favored by free market forces.

I believe that it is vital to the national interest to move quickly to eliminate takeover abuses. I think that goal can be accomplished with the legislation I propose.

THE BUST-UP TAKEOVER PROBLEM

"Greenmail" has become part of our everyday vocabulary and takeover abuses have become a pressing national problem. During the past three years there has been sharp growth in highly-leveraged takeovers by entrepreneurs who are not interested in operating the target companies, but seek the opportunity for profit through greenmail, bust-up liquidation of the target or forcing a white knight transaction that usually also results in bust-up liquidation of the target. These takeovers are not for the purpose of diversification, expansion or growth, but are financial transactions for the profit of the takeover entrepreneurs. They do not

add to the national wealth. They merely rearrange ownership interests by substituting lenders for shareholders and shift risk from equity owners to creditors. They place our banking system and credit markets in jeopardy and restrict the ability of the affected businesses to grow and provide increased productivity and employment.

The President's Council of Economic Advisers and the Office of Management and Budget, as well as a large number of private economists, argue that hostile takeovers move the assets of the targets into the hands of more efficient management and therefore are economically desirable. This is correct with respect to soundly-financed acquisitions by operating companies that are seeking to diversify or expand. Mergers by successful operating companies have been an integral part of our economic development. They should not be restricted. They improve the economy. But this is not true with respect to bust-up liquidation takeovers by takeover entrepreneurs. They do not move assets into more efficient management. They move assets into hands that profit by reducing expenditures for research and development and capital improvements. After a highly-leveraged takeover, a very high percentage of the revenues produced by the acquired assets are diverted to paying the debt incurred to acquire the assets.

The situation can be analogized to a farmer who

does not rotate his crops, does not periodically let his land lie fallow, does not fertilize his land and does not protect his land by building fences, planting cover and creating windbreaks. In the early years he will maximize his return from the land. It is a very profitable short-term use. But inevitably it leads to a dust bowl and economic disaster.

A policy favoring bust-up takeovers is a policy that favors the present at the expense of the future. It is consistent with economic policies and political decisions that result in huge deficits in the national budget. Those deficits also benefit the present at the expense of the future. The reasoning of the Council of Economic Advisers and the Office of Management and Budget with respect to takeovers is not different from that which results in the national deficits. These policies are not sound. Unfortunately, the future has no political constituency.

The shares of most companies that devote a significant part of their cash flow to research and development and capital investment sell in the stock market at a discount from liquidation value. The stock market discounts substantially the profits that will be produced in the future by investment in research and development and capital improvements. The market today prefers immediate shareholder realization of the present value of the investments that would

otherwise finance the research and development and capital improvements that would provide long-term growth and future profits to shareholders.

In addition, our accounting conventions and tax laws favor highly-leveraged acquisitions over direct research and development and new product introduction expenditures and capital investments. The ability to capitalize and defer for up to 40 years the amortization of acquisition premiums makes takeovers more attractive from an accounting standpoint than those expenditures which must be charged against income immediately or over a relatively short period. The ability to deduct interest on debt, but not dividends on stock, makes high leverage more attractive than sound balance sheets. These are arbitrary tax and accounting policies which, although in effect for many years, have no fundamental justification. It is time that their serious adverse impact on the economy is recognized and corrected.

Institutional investment managers prefer short-term gains to long-term growth. Institutions will accept any premium over the current stock market price rather than hold a portfolio investment for appreciation in the future. This investment policy is mandated by the competitive necessity for institutional investment managers to show better performance than the market as a whole and other investment managers.

New business flows to investment managers on the basis of their investment performance compared to each other and to the stock market as a whole. Thus, they have a strong incentive to focus on short-term portfolio performance rather than long-term investment. This leads investment managers not just to accept any takeover premium that is available, but to go further and join forces with the takeover entrepreneurs to force companies to effect any takeover that will produce a premium over current market. Takeover entrepreneurs have gained the active support of major institutional investors.

This further exacerbates the bust-up takeover problem. Since most of the large publicly-held companies are effectively controlled by institutional investors, the coordinated activity of takeover entrepreneurs and institutional investors threatens every large public company that sells in the stock market for less than its liquidation value with a bust-up takeover. At a Labor Department hearing on January 15, 1985, Mr. Jesse Unruh, the Treasurer of California, announced the formation of the Council of Institutional Investors to coordinate the actions of institutional investment managers on such matters as takeovers and stated that by banding together the institutions could exert "incredible force" over corporate managements. Subsequently, Mr. Unruh's Council played an active role in the attempt to take over the Phillips

Petroleum Company and supported the takeover entrepreneur who was seeking to force the bust-up of Phillips.

We have entered the era of the two-tier, front-end loaded, boot-strap, bust-up, junk bond takeover. Day after day the takeover entrepreneurs are maximizing their returns at the expense of future generations that will not benefit from the research and development and capital investments that takeover entrepreneurs are forcing businesses to forego. The message is clear. If a company wants to avoid being taken over and busted up, it must sacrifice long-term growth and future profits. It must use the maximum amount of leverage and operate with the primary objective of short-term profitability. This may in the short run save it from the liquidator but, like the farmer who ravages his land, it will ultimately succumb to the advantages enjoyed by its foreign competitors who are not hindered by outmoded tax laws and accounting conventions and who are not prey to takeover entrepreneurs and the investment managers who encourage them.

The acute problem is not greenmail. It is the bust-up takeover and the extreme leverage that is being built into the structure of American business. While different in form, what we face today is not different in substance from what happened in 1928 and 1929. Leverage produces great results on the way up, but no economy ever goes up in a straight

line and high leverage inevitably produces a crash when an economy turns down.

It is clear that abuse of the corporate takeover process has become a serious problem and is a threat to the economic system of the United States. On the other hand, as the takeover entrepreneurs have grown more aggressive, corporations have been forced to respond with defensive mechanisms to match them. While these mechanisms may be necessary to protect against abusive takeover tactics, they can affect the normal voting processes of the corporation's shareholders and may have other regrettable impact on corporate democracy. The net effect of the entire situation is that shareholders are hurt and American business is hurt.

Any successful solution must attack the problem as a whole, rather than focusing on particular symptoms. The legislation I propose is a balanced, cohesive approach to corporate takeover abuses. Its net effect is to curb takeover abuses and promote true corporate shareholder democracy. At the same time, unlike some recent legislative proposals, it preserves the traditional role of the states in regulating corporations. It does not deter takeovers, and it does not encourage management entrenchment. Nor does it add federal or Securities and Exchange Commission regulation. It deregulates rather than adds to regulation. It returns corporate

power to shareholders while concurrently giving them necessary protection against speculators who would profit at the corporation's and the shareholders' expense.

PROPOSED LEGISLATION

The proposed legislation would amend the Securities Exchange Act of 1934. First, the legislation would provide that, with certain exceptions, the acquisition of more than 5% of the outstanding shares of voting stock of a publicly held corporation could only be accomplished by an offer for all of the corporation's shares. The offer could be for cash or securities or a combination of cash and securities. In order to allow for legitimate passive investment, an institutional investor would be allowed to acquire up to 10% of the outstanding shares for investment purposes only, but would not be allowed to participate in any way in seeking a change of control until five years after reducing its holdings below 5%. Excepted entirely from the 5% limit would be proxy groups (unless they were seeking a merger, sale of substantial assets or other business combination), existing holders of 5% or more on the effective date of the legislation, acquisitions by or from the corporation, by an employee benefit plan or pension fund of the corporation, by a subsidiary of the corporation or with the approval of the corporation, and intra-family transfers.

By means of this provision, while legitimate investment will be protected, two-tier bids that pressure shareholders and favor market professionals over unsophisticated investors will be eliminated. Greenmail will also be eliminated. The would-be greenmailer will no longer be able to threaten to harm the corporation's shareholders with a creeping, two-tier or partial takeover attempt. In addition, the 5% limit on creeping acquisitions will eliminate the incentive to pay greenmail to buy back a 5% or larger block because larger blocks could no longer be created and a less than 5% block could easily be recreated.

Based on the protection provided by the 5% limit, the proposed legislation will also require shareholder approval before a corporation could repurchase its own shares from a holder of 3% or more of the corporation's voting securities at a premium above market (unless an offer of equal value were made to all holders of shares of the same class). In the current takeover environment, restricting corporations from paying greenmail would simply channel the efforts of creeping-acquiror takeover entrepeneurs into different avenues detrimental to unsophisticated investors. With the protection of the 5% limit, however, the 3% proscription on greenmail is appropriate and will eliminate greenmail without encouraging the takeover entrepeneurs to pursue other abusive tactics.

The proposed legislation will extend the period during which a tender offer must be held open from the present 20 business days to 60 calendar days. In conjunction with this amendment, the present statutory provision allowing securities deposited pursuant to a tender offer to be withdrawn after 60 days would be amended to allow withdrawal after 90 days. Extension of the tender offer period will give shareholders and boards of directors needed time to evaluate fully the merits of an unsolicited tender offer without being subjected to the kind of intense pressure that now often leaves a board with no choice but to act hastily and, in some cases, rashly. Because the time pressure on boards of directors will be lessened, many actions that are justifiable in the pressured context of a 20-day offer period may be found to be inappropriate in the new context of a 60-day offer period. This will permit the state courts to give new content to the business judgment rule as applied to takeover decisions.

Because the 5% limit on creeping acquisitions and extension of the tender offer period to 60 days will, to a great extent, curb abusive offensive takeover tactics and reduce the undue pressures now placed on directors in the takeover context, it becomes possible to mandate a high degree of shareholder democracy without the fear that share-

holders will be taken advantage of in the process. To this end, the proposed legislation would provide that a corporation's shares could not be traded on a national securities exchange or through a national securities association unless (a) all of the corporation's common stock has one vote per share and (b) the corporation's common stock represents at least a majority of the voting power for directors of the corporation. This provision would become effective as of December 31, 1986, but the Securities and Exchange Commission would have the power to provide exemptions, in order to accommodate corporations unable to modify their governing instruments by the effective date and otherwise to avoid undue hardship and disruption to the securities markets. In conjunction with this provision, the proposed legislation would allow free and equal access to the corporate proxy machinery for candidates for election as directors who were nominated by shareholders with 3% of the corporation's outstanding voting power or $500,000 in market value of the corporation's shares, whichever is higher. These thresholds will prevent shareholders and corporations from being plagued by proxy statement gadflies but at the same time assure that any substantial shareholder can submit to a shareholder vote any takeover proposal or change in corporate management. It is assumed that in its rulemaking and enforcement activities implementing these provisions, the Securities and Exchange Com-

mission will be able to eliminate or curtail voting trusts, long-term proxies, supermajority charter provisions, staggered election of directors, standstill agreements and other devices that effectively deprive the holders of a majority of the common stock of a corporation from the unfettered ability to elect a majority of the directors and thereby influence corporate policy and management.

Finally, the legislation would amend Section 13(d) of the Securities Exchange Act of 1934 by lowering the threshold level at which a person must report beneficial ownership from 5% to 3% of a public company, and concurrently tightening the reporting exemption for acquisition of no more than 2% of the company's shares in a 12 month period to no more than 1%. This change is necessary in order to facilitate the provisions prohibiting greenmail repurchases from a 3% holder and allowing free and equal access to the corporate proxy machinery for candidates for director nominated by holders of 3% of a corporation's stock. Because of the 5% limit on creeping acquisitions, however, no other changes to Section 13(d) would be necessary.

The proposed legislation, as a whole, would restore control of the public corporation to its shareholders without allowing self-seeking takeover entrepeneurs to take

advantage of those shareholders. It would allow direct corporate accountability and responsibility in a context that will promote fair and equal treatment. It is a precise, balanced approach that encourages fair takeover offers and gives shareholders the ability to decide the fate of those offers and the future of their corporations.

By effectively barring the most abusive offensive takeover tactics, the proposed legislation will remove any incentive corporate managements might have to engage in abusive defensive tactics. The new federal approach will thus allow state courts to apply the business judgment rule in a new context. With the shareholder protections and reduction of pressure embodied in this legislation, certain management measures may no longer be necessary or entitled to the protection of the business judgment rule, even as presently interpreted. At the same time, the legislation will not impinge on the states' historical role in fashioning corporate law.

Finally, by restoring shareholder democracy, this proposed legislation will mean that shareholders, once again, are assured of the best deal. This proposed legislation is the answer to the critical policy issues recently cogently summarized by former Securities and Exchange Commissioner Francis M. Wheat in these words:

To sum up, we have a situation in which the hostile takeover, once rare in corporate life, has become commonplace. Clear advantage lies with the raider unless the target company takes radical defensive measures. Only thus can it hope to remain independent if its directors believe the time is not ripe for sale. Accordingly, targets, their lawyers and their investment bankers have been ingenious in devising defenses, only a few of which have a solid chance of success. Alas, those are the very defenses that will inevitably result in loss of important assets, increased vulnerability to recession, partial or complete disenfranchisement of public shareholders, or all three. Meanwhile, large amounts of management time and effort are diverted from management's primary job and, where the focus of management is on the business, short-term results are likely to receive undue attention. It is astonishing to me that these deleterious effects, which the practicing lawyer in the field cannot help but see, are well-nigh invisible to those economists of the Chicago school (and their special friends among law professors) who are in love with takeovers. Before and after market prices (like the pictures of the fat lady who took the reducing pills) appear to be their principal, if not their only, analytical ground.

There is no doubt that most of the defensive measures which companies take are bad. The Commission has sought legislation which would place severe limitations on certain of these defensive measures, although its effort now seems to be running counter to the latest administration position that <u>any</u> legislation on the subject of tender offers is unnecessary and would be an intrusion into the province of state law. Last spring, the head of the Commission's Division of Corporation Finance suggested that the business judgment rule should be modified in the hostile takeover context. He would place the burden of justification for defensive actions on the target's management and board of directors, rather than the reverse. Alas, in my humble judgment, the Commission has focused on the symptoms and not on the disease. As long as the hostile takeover is a growing threat, it will be countered by a growing panoply of defenses. And recent indications are that the business community will not

> stand for the enactment of measures which severely weaken the ability of companies to defend themselves, by whatever means.
>
> It is my suggestion that we cease to wring our hands over the symptoms and consider steps to root out this malady.

The Shareholder Protection and Elimination of Takeover Abuses Act of 1985 is designed to root out the malady.

ANALYSIS OF PROPOSED LEGISLATION

1. Section 1 of The Shareholder Protection and Elimination of Takeover Abuses Act of 1985 (the "Protection Act") adds a new subsection (h) to Section 14 of the Securities Exchange Act of 1934. The new subsection provides that the acquisition by any person of voting equity securities which would entitle that person to cast 5% or more of the votes entitled to be cast in the election of directors of a publicly held company must be by means of a tender offer or exchange offer (or a combination tender offer and exchange offer) that includes an offer for all of the corporation's common stock. This limit does not apply to acquisitions by a proxy group not seeking a merger, sale of substantial assets or other business combination (so long as the individual members of the group comply with the limit), continued holding by a holder of more than 5% of the corporation's voting power on the effective date of the legislation, acquisitions by or

from the corporation, by an employee benefit plan or pension fund of the corporation, by a subsidiary of the corporation or with the approval of the corporation, and intrafamily transfers. In addition, an institutional investor will be allowed to acquire up to 10% of the corporation's shares for passive investment purposes only, provided that such an investor may not change its passive investment intent for a period of five years after reducing its holding below 5%. The definition of an institutional investor used in the Protection Act is derived from Rule 13d-1(b)(1) under the Securities Exchange Act of 1934, which prescribes the requirements for a Schedule 13G as opposed to a Schedule 13D filing. The definition of person includes two or more persons acting in concert or in a coordinated or consciously parallel manner, even if not pursuant to an express agreement.

This provision does not regulate the price at which or the consideration by which the tender offer or exchange offer must be made. Because the threshold for non-tender or exchange offer purchases is set at 5%, shareholders are sufficiently protected without having to require that the offer price be at least equal to the highest per share price paid by the acquiror in purchasing stock prior to the offer. If the limit were higher than 5%, "fair" price protections would have to be included. This provision also allows offers to

be made for cash, securities or a combination of cash and securities. There is no requirement that, in a combination offer where shareholders can choose between cash and securities, the cash and securities be of equal value because, by its terms, the same offer must be made for all shares to all shareholders. In the context of a 60 day offer (as is required under Section 3 of the Protection Act) where shareholders will have adequate time to evaluate the alternative forms of consideration, the market force of the alternative elections together with full proration will protect the shareholders' ability to receive equal value for their shares.

In addition, this provision permits any form of acquisition, including partial and two-tier acquisitions, with the approval of the corporation. Under the corporation laws of most states, this power would be exercised by the board of directors of the corporation. In addition, in some circumstances, shareholder approval is required for acquisitions above a certain level. In this manner, the flexibiliy afforded by state law is maintained to allow, among other things, venture capital investments and partial offers that the corporation determines are advantageous to all shareholders. This provision also facilitates saleability of existing large blocks of stock.

2. Section 2 of the Protection Act adds a new sub-

section (i) to Section 14 of the Securities Exchange Act of 1934. The new subsection requires shareholder approval before a publicly traded company may purchase, at a premium over the market price, any of its voting securities from any person who holds more than 3% of the class of voting securities to be purchased, unless such purchase is part of an offer made at the same price to all holders of such securities. The Securities and Exchange Commission is given power to grant exemptions from this provision.

This provision recognizes that with the 5% limit on creeping acquisitions embodied in Section 1 of the Protection Act, there is little incentive for a corporation to pay greenmail (i.e. repurchase a block of shares from a large holder at a premium price). This is because no larger block than 5% may be accumulated (except through an offer for all the shares), and a 5% block could easily be recreated. Without the protections of Section 1, the restriction on repurchase at a premium would not be advisable. With those protections, however, this provision can be expected to eliminate greenmail without encouraging other takeover abuses. Section 2 does not define "market price". It is anticipated that the Securities and Exchange Commission will develop a definition of market price which will take into account the prices of securities as reflected on securities exchanges, or for securities not listed

on any exchange, the average bid and asked prices as quoted on a quotation system or as furnished by a professional market maker. It is not intended that this provision restrict the purchase of debt or other nonvoting securities.

3. Section 3 of the Protection Act amends Section 14(d) of the Securities Exchange Act of 1934 to extend the period during which a tender offer must be held open from the present 20 business days to 60 calendar days, and to extend the time after which securities tendered may be withdrawn from the present 60 days to 90 days.

Although extension of the tender offer period might be argued to deter offers, the overall effect of the Protection Act is to remove many deterrents to offers and, within this context, extension of the tender offer period is necessary. Extension of the tender offer period will also allow courts, in applying the business judgment rule, to reject the argument that extreme defensive tactics are justifiable because they are necessary to "buy time" in looking for alternatives to the offer. With sufficient time, defensive tactics that under pressure seem to be the only alternatives available to a corporation may turn out to be the less desirable of a number of alternatives.

4. Section 4 of the Protection Act adds a new sub-

section (j) to Section 14 of the Securities Exchange Act of 1934. The new subsection provides that a company's shares may not be traded on a national securities exchange or through a national securities association unless each share of the company's common stock has one vote, and a majority of the voting power for directors of the company is held by the common stock. The subsection gives the Securities and Exchange Commission the power to grant temporary exemptions from this provision in order to accommodate corporations unable to modify their governing instruments by the effective date and otherwise to avoid undue hardship and disruption to the securities markets. It is assumed that in its rulemaking and enforcement activities under this subsection the Securities and Exchange Commission will be able to secure the elimination of voting trusts, long-term proxies, supermajority charter provisions, staggered election of directors, standstill agreements and other devices that effectively deprive the holders of a majority of the common stock of a corporation from the unfettered ability to elect a majority of the directors and thereby influence corporate policy and management.

This subsection is designed to protect shareholder democracy and corporate accountability. In the context of the protections provided by Sections 1 and 3 of the Protection Act, this subsection removes a number of potential deterrents

to those takeover offers that are fair to shareholders. Together with Section 5 of the Protection Act, this provision ensures that Sections 1 and 3 of the Protection Act are purely shareholder protection measures and cannot be used to diminish or insulate managers and directors from responsibility and accountability. This subsection is not intended to interfere with issuance of stock for use in connection with innovative acquisition or financing techniques that do not entrench management or preclude the effective exercise of shareholder democracy.

5. Section 5 of the Protection Act amends Section 14(a) of the Securities Exchange Act of 1934 to provide that a beneficial owner of voting securities of an issuer representing the greater of 3% of the voting power of such issuer or $500,000 in market value is entitled to free and equal access to the corporate proxy machinery for such beneficial owner's nominees for director, on an equal basis with candidates nominated by the issuer's management or board of directors.

As with Section 4 of the Protection Act, this provision encourages director accountability and responsibility. While Sections 1 and 3 of the Protection Act reduce the potential for unfair treatment of shareholders and detrimental pressure on directors, Sections 4 and 5 restore whatever director accountability might otherwise be lost, and remove

deterrents to fair takeover attempts. The threshold for access to the corporate proxy machinery is set at 3% or $500,000 of the corporation's voting securities (whichever is higher) in order to protect against abuse of such access by "proxy statement gadflies" but at the same time to assure that any substantial shareholder can submit to a shareholder vote a proposal for a change in corporate management. The access to the proxy machinery provided by Rule 14a-8 under the Securities Exchange Act of 1934 would remain intact and would supplement the new provision.

6. Section 6 of the Protection Act amends Section 13(d) of the Securities Exchange Act of 1934 to reduce the threshold at which a beneficial owner of securities must report such ownership from 5% to 3%, and to tighten the reporting exemption for acquisitions within a twelve month period from 2% to 1%. This lower threshold is necessary in order to facilitate enforcement of Section 2 of the Protection Act, which requires shareholder approval of certain premium repurchases of stock from a 3% holder, and Section 5 of the Protection Act, which mandates free and equal access to the corporate proxy machinery for candidates for director nominated by holders of 3% (or, if higher, $500,000 in market value) of a corporation's stock. No other amendments to Section 13(d) are necessary in light of the 5% limit on creeping acquisitions embodied in Section 1 of the Protection Act.

TEXT OF THE SHAREHOLDER PROTECTION AND
ELIMINATION OF TAKEOVER ABUSES ACT OF 1985

Section 1. Section 14 of the Securities Exchange Act of 1934 is amended by adding the following subsection (h):

(h)(1) It shall be unlawful for any person, directly or indirectly, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, to acquire or agree to acquire any shares of any class of voting equity securities of a corporation registered pursuant to section 12 of this title, or any shares of any class of voting equity securities of an insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of this title, or any shares of any class of voting equity securities issued by a closed-end investment compay registered under the Investment Company Act of 1940 if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of voting equity securities which would entitle such person to cast 5 percent or more of the votes that all holders of outstanding voting equity securities would be entitled to cast in an election of directors of the issuer, unless such acquisition shall

be by means of a tender or exchange offer (or a combination of a tender offer and exchange offer) which includes an offer for all of the outstanding shares of common stock of the issuer (including all shares of common stock issuable upon conversion or exercise of outstanding securities, warrants, options or other rights issued or granted by the issuer).

(2) The provisions of this subsection shall not apply to:

(A) any person that on the effective date of this subsection beneficially owns voting equity securities of a corporation which would entitle such person to cast 5 percent or more of the votes that all holders of outstanding voting equity securities would be entitled to cast in an election of directors of the corporation unless, subsequent to such effective date, such person increases its beneficial ownership of voting equity securities of the corporation to a percentage in excess of the percentage of outstanding voting equity securities of the corporation beneficially owned by such person on such effective date;

(B) acquisitions of any voting equity security by the issuer of such security;

(C) acquisitions of any voting equity security from the issuer of such security;

(D) acquisitions of voting equity securities pursuant to an agreement with the issuer;

(E) acquisitions of voting equity securities by gift or inheritance or by transfer from an existing holder to an individual related to such holder by blood or marriage;

(F) acquisitions of voting equity securities of any issuer that on the effective date of this subsection and on the date of such acquisition is a subsidiary of any other corporation by such other corporation or any other subsidiary of such corporation;

(G) acquisitions by an institutional investor of voting equity securities of any issuer that would entitle such institutional investor to cast 5 percent or more, but less than 10 percent, of the votes that all holders of voting equtiy securities would be entitled to cast in an election of directors of the issuer; provided, however, that such institutional investor shall not seek, or in any way aid

or assist any other person in seeking, to influence or control the management, board of directors or policies of such issuer until at least five years after such institutional investor reduces its ownership to that number of voting equity securities that would entitle such institutional investor to cast less than 5 percent of the votes that all holders of voting equity securities would be entitled to cast in an election of directors of the issuer; or

(H) acquisitions of voting equity securities of any issuer by an employee benefit plan or pension fund of such issuer.

(3) For purposes of this subsection:

(A) The term "person" shall include two or more persons acting in concert or in a coordinated or consciously parallel manner (whether or not pursuant to an express agreement) or as a partnership, limited partnership, syndicate, or other group (whether or not organized) for the purpose of acquiring, holding, or disposing of securities of an issuer, or influencing the management policies of an issuer;

provided, however, that two or more persons acting in concert or in a coordinated manner shall not be deemed a "person" for purposes of this subsection if (A) they are existing holders of voting equity securities of an issuer, (B) they are acting in concert or in a coordinated manner solely for the purpose of soliciting proxies from other holders of voting equity securities of the issuer or otherwise seeking to influence the management policies of the issuer, (C) no such existing holder has acquired any voting equity security of the issuer other than as set forth in paragraph (1) of this subsection, and (D) they have no intent to effect and are not seeking or proposing a merger, sale of substantial assets, or other business combination involving the issuer and themselves or any other person;

(B) the term "voting equity security" means any equity security of a corporation that entitles the holder thereof to vote generally in an election of directors of the corporation;

(C) the term "subsidiary" means any issuer as to which another corporation beneficially owns voting equity securities that would entitle such corporation to cast at least 50 percent of the votes that

all holders of outstanding voting equity securities of the issuer would be entitled to cast in an election of directors of the issuer; and

(D) the term "institutional investor" means (i) a broker or dealer registered under Section 15 of this title; (ii) a bank as defined in Section 3(a)(6) of this title; (iii) an insurance company as defined in Section 3(a)(19) of this title; (iv) an investment company registered under Section 8 of the Investment Company Act of 1940; (v) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; (vi) an employee benefit plan, or pension fund which is subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA") or an endowment fund; (vii) a parent holding company, provided the aggregate amount of the subject class of voting equity security held directly by the parent, and directly and indirectly by its subsidiaries which are not persons specified in clauses (i) through (vi) of this subparagraph, does not exceed one percent of such class of voting equity security; or (viii) a group, provided that all the members are persons specified in clauses (i) through (vii) of this subparagraph.

Section 2. Section 14 of the Securities Exchange Act of 1934 is amended by adding the following subsection (i):

(i)(1) It shall be unlawful for an issuer to purchase, directly or indirectly, any of its voting equity securities at a price above the market price of such securities from any person who holds more than 3 percent of the voting equity securities of the issuer, unless such purchase has been approved by the affirmative vote of a majority of the aggregate voting equity securities of the issuer, or is pursuant to an offer at the same price (or equivalent per share price) made to all holders of securities of such class and to all holders of any class into which such securities may be converted.

(2) The term "voting equity security" has the same meaning as defined in paragraph (h)(3)(B) of this section.

(3) The Commission may, by rule, regulation, or order, in the public interest or for the protection of investors, and subject to such terms and conditions as may be prescribed therein, provide exemptions from the provisions of this subsection.

Section 3. Subsection 14(d) of the Securities Exchange Act of 1934 is amended by deleting the word "sixty" in

current paragraph (5) and inserting in its place the work "ninety", and by renumbering current paragraphs (5), (6), (7) and (8) as paragraphs (6), (7), (8) and (9), and inserting the following as paragraph (5):

(5) Any person making a tender offer or request or invitation for tenders shall hold such offer, request or invitation open for a period of at least 60 days from the date on which the statement required by paragraph (1) of this subsection with respect to such offer, request, or invitation is filed with the Commission, except that this paragraph shall not apply to such an offer, invitation, or request by the issuer for the class of securities being sought if such offer, invitation, or request is not make in anticipation of or response to another person's offer, request, or invitation for tenders for securities of the same class.

Section 4. Section 14 of the Securities Exchange Act of 1934 is amended by adding the following subsection (j):

(j) It shall be unlawful for any member, broker, or dealer to effect any transaction after December 31, 1986 on a national securities exchange, or through a national securities association, in any security (other than an exempted security) of an issuer if:

(1) any of such issuer's common stock or any class of such common stock has fewer or greater than one vote per share on any issue to come before such issuer's shareholders (before giving effect to any right of such shareholders to cumulate votes in an election of directors); or

(2) the number of votes which such issuer's common stock, in the aggregate, entitles the holders thereof to cast in an election of directors of such issuer is less than a majority of the total number of votes entitled to be cast in such an election of directors;

provided, however, that the Commission is authorized to promulgate rules providing for exempticns from the operation of this subsection (j) or portions hereof to any issuer for up to three years after December 31, 1986 in those circumstances where the Commission determines that the earlier application of this subsection (j) or portions thereof would cause undue hardship or disruption of the securities markets.

Section 5. Subsection 14(a) of the Securities Exchange Act of 1934 is amended by adding the following provision:

There shall be included in any proxy statement or other communication with respect to the election of direc-

tors, sent by any issuer to its shareholders pursuant to this subsection, descriptions and other statements of or with respect to any candidates for election as directors nominated by any person who is the beneficial owner of voting securities of such issuer representing the greater of (1) 3% or more of the voting power of such issuer's securities or (2) $500,000 in market value. Such descriptions and other statements shall be submitted by or on behalf of such candidates, shall receive equal space, coverage and treatment as is received by candidates nominated by the board of directors or management of such issuer, and shall be subject to such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 6. Section 13(d) of the Securities Exchange Act of 1934 is amended by deleting the phrase "5 per centum" in paragraph (1) thereof and inserting in its place the phrase "3 per centum" and by deleting the phrase "2 per centum" in paragraph (6)(B) thereof and inserting in its place the phrase "1 per centum."

Senator D'AMATO. Thank you very much, Mr. Lipton. Mr. Montgomery.

STATEMENT OF PARKER G. MONTGOMERY, CHAIRMAN OF THE BOARD, COOPERVISION, INC., AND CHAIRMAN OF THE BOARD AND PRESIDENT, COOPER LABORATORIES, INC.

Mr. MONTGOMERY. Thank you, Senator D'Amato.

I welcome the opportunity to testify before this Subcomittee as it considers what legislation, if any, is needed in the area of takeovers.

I speak as a businessman and investor with some experience relating to acquisitions. I am Chairman of the Board and Chief Executive Officer of Cooper Laboratories, Inc., which I helped to found in 1958. I am also Chairman of the Board and Chief Executive Officer of CooperVision, Inc., CooperBiomedical, Inc. and Cooper LaserSonics, Inc.

Prior to founding Cooper Laboratories, I practiced law with the Boston firm of Heminway and Barnes and the New York firm of Dewey, Ballantine, Bushby, Palmer and Wood and worked with the investment banking firm of Baker, Weeks & Co. From 1959 through 1961, I served as Special Assistant to the United States Secretary of State, Christian A. Herter.

I am former Vice Chairman of the President's Task Force on International Private Enterprise, and serve as a director of the California Chamber of Commerce and a director and member of the executive committee of the National Association of Manufacturers. I am also a member of the American Business Conference, the California Roundtable, and the Council on Foreign Relations.

Today, I would like to discuss the importance of preserving the traditional right of shareholders to decide for themselves whether to respond to tender offers for their shares in publicly traded companies. That right is at the cornerstone of existing congressional regulation of tender offers. AND NOW THAT RIGHT IS BEING SEVERELY THREATENED BY THE LATEST OF A SERIES OF ANTI-TAKEOVER DEVICES WHICH HAVE BEEN CONCOCTED BY THE LEGAL COUNSEL FOR CERTAIN CORPORATE MANAGEMENTS. This latest concoction is what's being called the Poison Pill.

First, let's take a look at shareholders' rights under existing federal legislation.

The centerpiece of federal legislation with respect to tender offers is the Williams Act, which was enacted by Congress in 1968.

In that legislation, which is embodied in Sections 13 and 14 of the Securities Exchange Act, Congress was clearly concerned that shareholders should have a fair opportunity to make informed choices with respect to tender offers. Congress required that all offers must be open for a specified period of time. It also required there must be full disclosure to shareholders regarding information about the maker of the tender offer, as well as any recommendation made by management concerning the tender offer.

Congress deliberately adopted a policy of evenhandedness, and structured the Williams Act so as not to give an advantage either to the bidder or to the management. The purpose of the legislation was plainly "to get information to the investor...and then to let the investor decide for himself."[1]

Both the Senate and the House reports on the Williams Act make it clear that Congress intended that shareholders have the right, once they are fully informed by the required disclosures, to make the decision whether or not to tender their shares.

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1. Takeover Bids: Hearings on H.R. 14475 and S.510 before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 90th Cong., Second Sess. 4, 47-48 (1968).

According to both reports: "This bill is designed to make relevant facts known so that shareholders have a fair opportunity to make their decision."[2]

Now let's look at how the Poison Pill threatens traditional shareholder rights.

The first Poison Pill was introduced two years ago. Its use is accelerating rapidly, and there are already some fourteen companies that have adopted Poison Pills. Now sometimes these show up under the euphemism "share rights purchase plans" or comparable names. But they are more commonly, and correctly, known as Poison Pill plans. The name derives from the issuance of so-called "rights" to a company's shareholders which are poisonous (as I'll describe shortly) to a prospective acquiror.

Companies which so far have adopted Poison Pills -- always without shareholder approval, merely by action of the board of directors -- are Bell & Howell, Crown Zellerbach, Colgate Palmolive, Enstar, General Host, Household International, Jerrico, Johnson Controls, Morton Thiokol, Owens Illinois, Phillips Petroleum,

2 S.Rep No. 550, 90th Cong., First Sess. 3; H.R. Rep. No. 1711, 90th Cong., Second SESS. 4 (1968).

that the directors of Rorer redeem or otherwise eliminate the Poison Pill. I understand the Rorer Poison Pill is very similar to the pills adopted by the other companies I have named. This is not surprising, since the bulk of the Poison Pill plans have been spit out of the word processing equipment of one New York law firm -- Wachtell, Lipton, Rosen & Katz -- which often represents the management of target companies.

On February 7, Rorer's directors declared a distribution of one "share purchase right" for a common share of Rorer. There are more than 21 million common shares outstanding, and now there are more than 21 million Poison Pills. These "rights," or Poison Pills, do not become exercisable until a third party acquires 20% or more of Rorer's shares. Each Poison Pill, once it becomes exercisable, purportedly gives two "rights" to a holder. Neither right, in our view, has any economic value:

First, there is a "right" to buy a share of Rorer for $90. But because Rorer stock now trades around $30 per share, this "right" has virtually no present value, and no sensible person would consider exercising this illusion, this so-called right.

Rorer Group, Southwest Forest Industries and Wainoco. These are not insignificant companies. No doubt -- right now there are many other companies considering the adoption of comparable Poison Pill plans.

Just what does this trend mean?

I believe the Poison Pill would mean the virtual end of any tender offer not approved by management. It would mean that a bidder for a company could no longer take its case directly to the real owners of the company -- the shareholders, as had been the case since before the Williams Act, unless the management of the company first gives its blessing to the offer. I submit the result would be a substantial and immediate harm to all shareholders, and would lock-in the inefficiencies in an already well-entrenched American corporate management.

How does the Poison Pill work? How does it deter tender offers? Let me illustrate it by discussing the Poison Pill plan adopted on February 7, 1985 by the directors of Rorer Group. I have selected this plan because I am familiar with it. Cooper Laboratories is a substantial shareholder of Rorer, currently owning in excess of one million shares, or just under 5% of the outstanding Rorer shares. I should add that at the forthcoming Rorer annual meeting, Cooper Laboratories intends to propose a shareholder resolution requesting

But there is a second "right" -- a right that is exercisable in the event of a merger between Rorer and an acquiring company, to force the acquiring company to issue for each of the 21 million Poison Pills $180 worth of its stock for only $90. "This is the sleeper." This "right" sounds too good to be true -- and it is. I submit that no acquiring company should incur a $90 cost for each Poison Pill right, in addition to whatever price the acquiring company might be willing to pay for each Rorer share.

The net effect is that management digs an impregnable moat around itself. Let me run through an example.

Assume that a buyer is prepared to buy Rorer at a premium of 33% over the current market price -- $40 per share, or about $840 million for Rorer's 21 million shares. Let me emphasize that I do not know of any such buyer; I merely intend to show how the Poison Pill works.

If the Poison Pill rights remain outstanding after 20% of the shares have been acquired, the buyer then faces the prospect of an additional $90 per share, or $1.9 billion expense upon exercise of the rights in the event of a merger with Rorer.

The Wachtell, Lipton firm has suggested that a buyer might try to guard against the poisonous effect of a Poison Pill by asking shareholders to tender their Pill rights as well as their shares.

That might sound good, but let's be realistic. This simply doesn't work.

Assume that a buyer makes an offer to buy Pill rights, as well as shares. Even if the buyer managed to acquire 80% of the Poison Pill rights, the remaining rights would still make the cost of acquiring Rorer prohibitive. In most any other situation, 80% approval would represent a clear mandate of shareholder approval. But not in the case of Rorer's Poison Pill. The additional cost to the buyer would still be some $380 million -- more than big enough, in my view, to deter the buyer from making its $40 offer in the first place.

I am not asking you to take only my word about the effect of the Poison Pill. In his letter to the shareholders, which is very similar to other letters from other Chief Executive Officers prepared on the Wachtell, Lipton word processors, Rorer's own Chairman, stated that the "rights" should "deter any attempt to acquire the Company in a manner or on terms not approved by the Board...."

I also suggest that the Subcommittee consider what the Securities and Exchange Commission and other independent shareholder representatives have said about the Poison Pill. In a case challenging Household International's Poison Pill, the SEC intervened on appeal to the Delaware Supreme Court, and stated in its brief:

> -"For twenty years, Congress and the Commission have consistently held the view that tender offers can benefit shareholders by offering them the opportunity to sell their shares at a premium, and by acting as a guard against the entrenchment of management, and that it is thus in the shareholders' interest to allow them the opportunity to consider and act on tender offers."

The SEC also said:

> -The Rights Plan gives "management an absolute veto over any tender offer. This plan simply will not allow a non-management approved tender offer to be made..."

The SEC went on to say:

> -"[T]he consistent view of Congress and of the Commission has been that the decision whether to accept or reject tender offers should be left, after full disclosure by management and bidders, to the shareholders. The Rights Plan...by giving the board a 'plenary negotiation role' on behalf of shareholders [is]....inherently contrary to the shareholders' interest."

The SEC concluded:

> -"Such a scheme, in our view, renders the Rights Plan inherently contrary to the shareholders' interests. It is our view that this plan is not justified and should not be sustained."

In the same case, the Investment Company Institute, a national association of mutual funds and investment advisers, also objected strongly to the Poison Pill.

The Institute's mutual fund members have over 20 million shareholders, most of them individuals, and have assets of approximately $345 billion.

In its brief, The Investment Company Institute stated that:

> -The Rights Plan "deprives...stockholders of their basic rights, as owners of the corporation, to decide for themselves whether to sell their stock, and how to maximize the value of their investments."

The Institute said:

> -"The Rights Plan deprives stockholders of important rights and economic benefits."

The Institute also said that:

> -The board of directors "has taken from the stockholders, and given to itself, the power to consider and pass upon all acquisition offers for the company and its shares."

I quote the Investment Company Institute further:

> -"A device like the Rights Plan...separates stockholders - the ultimate owners of a corporation - from the rights and benefits of their ownership. It replaces stockholder democracy with a system of corporate governance whereby the board of directors arrogates to itself...the power to decide the corporation's 'ultimate destiny', on the premise that the stockholders simply do not have the competence to make this decision for themselves."

At this point, let us look at the consequences of the denial of traditional shareholder rights.

Traditionally, shareholders have had a right to consider for themselves whether or not to accept a tender offer, which typically involves the payment of a substantial premium over market.

Please note, it is easy to document the kinds of premium that are typical in tender offers. The SEC's Chief Economist, in a recent study of tender offers between the years 1981 and 1983, found that shareholders received premiums over market value in tender offers of, on average, 31.3% for partial offers, 55.1% for two-tier offers and 63.4% for any and all offers.[3]

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3 49 Fed. Reg. 26755, 26760 Table 4 (June, 1984).

The Supreme Court itself has recognized the value of tender offer premiums to shareholders. It has said, where tender offers are blocked, and I quote:

> "Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced."[4]

In addition, I submit that the right to take an acquisition proposal directly to shareholders has an importance that cannot be measured simply by looking at the unsolicited tender offers that have been actually made. Because management knows that a buyer can go directly to shareholders, they are not only more inclined to talk to a prospective buyer, but, even in the absence of a prospective buyer, management is more likely to employ its corporate assets more effectively, therefore creating greater value for shareholders.

Edgar v. MITE Corp., 457 U.S. 624,643 (1982).

The free reallocation of capital resources is at the core of the tender offer process. I do not believe a decision to eliminate that freedom should be left to the untested judgments of those individuals who stand to gain from deterring tender offers by perpetuating their own control -- that is, incumbent management.

I cannot predict with any certainty the effect of such deterrence on the American economy. But my best judgment is that the effect would be to preserve inefficiencies and remove some of the incentives that presently keep management more responsive to the demands of the owner-shareholders. Therefore, the threat to individual shareholder's rights may well have macro-economic consequences that Congress has a legitimate interest in considering.

Well, there is the Poison Pill. But what is the antidote? Those who know me know I am rarely an advocate of additional legislation. In fact, I am testifying today basically in support of the existing pattern of even-handed regulation, as embodied in the Williams Act. I hope that additional federal legislation will not be necessary in this area.

I believe that the state courts will recognize the basic threat to traditional patterns of corporate governance presented by the Poison Pill. However, there's still a job to be done. I must note that the few lower courts which have thus far considered the matter have declined to give preliminary injunctive relief. As I understand it, this is in part because of the difficulty of showing immediate and irreparable injury until a board of directors has turned down an offer.

So, in a sense, the judicial attitude thus far is a Catch-22 situation.

The courts seem to be saying: let's wait to see whether the directors act unreasonably in turning down an acquisition offer -- when one is made. But the flaw here is that no hostile offers may ever be made. Because the Poison Pill deters a bidder from making an offer in the first place, the directors may never be confronted with an offer to turn down.

I believe the state courts will face up to the realities of the situation and recognize the illegality of Poison Pill plans. There is real harm to shareholders here. I believe shareholders -- institutions and individuals alike -- will speak out against this threat once they clearly understand that their freedoms are seriously jeopardized.

Because they are adopted without shareholder approval, Poison Pill plans are much more dangerous than shark repellent charter amendments, like supermajority voting provisions or staggered boards, which must be submitted to shareholders. Poison Pills are not only more powerful deterrents against tender offers than shark repellents, but they also are being put into effect without shareholder approval. I suspect this is because management is as nervous as a cat about how shareholders would react to a Poison Pill plan, if they were ever given the opportunity to vote on one.

Thank you very much for the opportunity to testify before you.

Mr. Chairman, this concludes my formal statement. I will be happy to answer any questions you may have.

Senator D'AMATO. Thank you, Mr. Montgomery.
Mr. Brinegar.

STATEMENT OF CLAUDE S. BRINEGAR, SENIOR VICE PRESIDENT AND MEMBER OF THE EXECUTIVE COMMITTEE AND BOARD OF DIRECTORS, UNION OIL CO. OF CALIFORNIA

Mr. BRINEGAR. Mr. Chairman, my name is Claude S. Brinegar. I am senior vice president and member of the board of directors of Unocal Corp. And I guess I'm exhibit A today on what happens when a company comes under direct attack for a hostile takeover. I will file in the record my full statement and I will take about 10 minutes to summarize the highlights of my statement.

Unocal is the parent company of Union Oil Co. of California, one of the Nation's remaining major integrated oil companies. Fred L. Hartley, our chairman and president, sends his regards and regrets, and asks that I express our appreciation for the chance to be here today.

I might say that since February 14, the day Mr. Pickens delivered his version of a valentine to us, both Mr. Hartley and I have done little else——

Senator D'AMATO. Did he do that on February 14?

Mr. BRINEGAR. February 14 at about 2 p.m.

Senator D'AMATO. A notable date.

Mr. BRINEGAR. We've done little else except deal with issues that were raised by that unexpected event.

We all know that memories are short, but we often forget how short. It was not many years ago that I was appearing before congressional committees when Congress was talking about an energy crisis and an energy need and urging and even demanding Unocal and other oil companies to step up their investment in exploration and development and to make long-term plans to find alternative energy sources to meet America's future needs. Now today and yesterday and in other places, I find I'm defending our rights to do just that, our rights to grow. Not long before that, in the years when people still remembered the depression, industrial companies—particularly those with high fixed costs—were urged to maintain healthy balance sheets, with a high ratio of equity to debt, so that they could better withstand changes in the business climate.

Now today, I find myself defending our right not to take on excessive debt.

RECEIVING A DIFFERENT MESSAGE

Today, oil companies are receiving a different message. This time the message is from takeover artists or raiders.

The message reads very simply: "Stop all this nonsense about trying to find oil in the United States. Instead, restructure yourself or else I'll do it for you."

What does restructure mean? As far as I can tell it means at the end of the game one of two things: It means liquidation, as the case of Cities Service, Gulf, and Getty; or it means a massive conversion of equity to debt, as it did in the case of Phillips.

This raiders game has been played repeatedly in recent months and, as I say, it is now being played at or with—I'm not sure—Unocal this very moment. The first step is to put a company in play by buying a block of stock, generally with borrowed money, and making a dramatic announcement, such as a takeover proposal or a vague restructuring recommendation. The proposal may or may not be a serious one—it doesn't seem to matter. Mesa Petroleum, for example, has not actually acquired any of the large companies it has threatened. But the game has enabled Mesa to make over $1 billion in stock gains and another $100 million in so-called expenses.

Indeed, the raider seems to hope that other investors seeking quick turn profit will buy stock in the expectation that something good will happen. Once enough of the target's stock is in the hands of short-term investors, their expectations become action-forcing events; a buyout financed by high-interest junk bonds; an exchange of debt for equity; and, frequently, a huge greenmail payment to the raider, enriching him with dollars that will not go either into exploration or to shareholders.

Some of the momentum behind the takeover bubble comes from sources that the Congress can do something about almost immediately. The momentum comes, first of all, from a federally protected banking and S&L environment in which loans at high-interest rates are so attractive to lenders that the institutions are racing

each other to participate. Momentum comes from the fact that greenmail can be demanded and received by raiders, and can be paid by targets, without penalty. And the momentum comes, finally, from a tax system that favors debt over equity.

FIVE MAJOR OIL COMPANIES

The full extent of the recent industry turmoil can be seen in attachment 1, which I would ask you to turn to briefly. It follows page 23 and I think it worth a moment. In exhibit 1, I've listed America's major integrated oil companies and their debt ratios 5 years ago and today. That exhibit shows that in 1980 there were some 15 major integrated companies, almost all with conservative debt burdens, competing with each other in the exploration, production, refining, and marketing of oil products in America—this column on the left.

But in less than 5 years, five of these companies have disappeared as independent entities and four others have taken on large debts, including Phillips which just last month was forced to take on a debt burden of record proportions, as the table on the right shows, a debt ratio of 80 percent. Mobil and Texaco have debt burdens of now over 40 percent. This is truly an extraordinary shift in the capability of an industry that provides perhaps 70 percent of America's oil exploration and certainly most of the exploration in the frontier regions of Alaska and elsewhere.

Unocal has become a raider's target not because we are unsuccessful, but rather because we have been successful. We have been successful in finding oil at low cost; we have been more profitable than most of our competitors and have provided better returns to our shareholders; and we have kept our debt burden low so that we could invest aggressively to find and produce oil and in the development of alternative energy sources we believe will be necessary for our Nation's future.

Mr. Chairman, members of the committee, when success in harnessing the Nation's energy resources brings on the destructive results of takeovers, then I believe something is seriously amiss in our Nation's financial and tax system.

Now I'd like to turn to page 12 and cover the points that I have at the end of my paper.

I think the question that could be asked is: Why is this happening to the large companies in the oil industry? Let me first tell you what is not the cause because it's been masquerading as the cause. It is not because this entire group shown in that table of U.S. integrated oil companies somehow suddenly needs to be restructured, though this is the claim Mr. Pickens puts forth as he did in his testimony on February 27 before a House committee, and I include that statement in my testimony. Indeed even yesterday in a House hearing he restated that this list of companies needed to be restructured—this gap in the market value versus his idea of an appraised value needs to be closed. I should note that closing that gap by the way it was closed with Phillips would cost the country about $80 billion in additional borrowing, something I consider to be nearly impossible. Carrying his line of reasoning to its extreme, every company listed in exhibit 1 either would be merged, liquidat-

ed, or decapitalized—that is, forced into a massive conversion of equity to debt, a la Phillips. This is an impossible result with impossible demands on the credit system; but it is also a result that, even if partly achieved, would certainly cripple an essential industry, an industry that is doing America's frontier exploration in drilling in offshore waters of Alaska and so forth.

As Eugene Nowak, an analyst at Dean Witter, said in a recent Washington Post article:

> This restructuring is forcing a strong orientation toward short-term performance and rewards at the peril of dramatically reducing future benefits. If it continues, I think there are dire consequences for the long-term energy supplies of the United States, and perhaps the trend could bring on an energy crisis sooner, rather than later.

Now let me turn briefly to why I think this is happening. I believe this is happening: First, because enormous amounts of money have become available for speculative short-term deals as a result of the move to deregulate financial institutions; some of those institutions are now acting foolishly, considering their responsibilities. They are buying high-risk debt and hoping it will all work out.

Two, because, with the emergence of junk financing, bidders can borrow 100 percent of the cost of an acquisition in advance, with little or no security, on the promise that they will bust up the target to repay the loan. They may not actually borrow the money, but it gives them the ability to threaten targets many times their size. And this was described in chilling detail in the January 1985 issue of Harpers.

OUTRAGEOUS COMMITMENT FEES

A related abuse of financial power is the payment of outrageous commitment fees to financial institutions by raiders and greenmailers who have thereby obtained a facade of financing for their tender offers. Through such commitment payments, which supposedly assure the borrower of possible financing, a raider or greenmailer conveys to the public the impression that he can finance an offer, fanning speculation in the marketplace and often stampeding management into a buyout or some other precipitous action, and I believe this is what happened with Gulf.

In some instances it is questionable whether the institution being paid the commitment fee has carefully scrutinized the implications of the loan that it is undertaking to guarantee. There can be a very real question whether the institution isn't simply gambling that the loan will never be taken up. Or is the institution being swayed by the commitment fee into overreaching on a risky loan? Is it a proper function of banks and financial institutions to act as accomplices in what I take to be corporate extortion?

Three, because the tax system, which permits the deduction of interest on borrowed money used for successful, unsuccessful or even threatened raiding, favors debt over equity; because it allows these commitment fees to be treated as business expenses; and because it favors the so-called investor over the businessman—the raider over the defender.

Fourth, because of the emergence of a group of professional raiders, whose interest is not in the overall health of the economy or in

helping true shareholders, but only in making quick-turn profits for themselves. I need not list them here. They have all been glamorized many times in articles in Time, Fortune, Business Week, Harpers, and elsewhere. They are becoming almost household names.

Five, most importantly, I believe in the case of the oil industry, Mr. Pickens especially has somehow created a speculative frenzy—his modern version of the South Sea bubble—that has convinced many on Wall Street that there's easy money to be made in attacking oil companies, and to hell with tomorrow. But this bubble, like all bubbles, will collapse, and when it does it will leave behind the wreckage of ruined companies, lost jobs, ruined careers, reduced U.S. oil production, failed banks and S&L's, and then Government bailouts.

Lest you think I'm exaggerating when I say that Mr. Pickens favors the restructuring of just about everybody—except of course Mesa which is surrounded by several layers of shark repellent—shark repellent beyond belief—let me offer some evidence.

As mentioned previously, I have in exhibit 2, an excerpt from his statement before a House committee on February 27. The table lists eight major companies by name and shows a gap in value that his so-called restructuring or his better management would close. But I'd like to tell this committee that Mr. Pickens' argument is wrong—it's dead wrong. The gap is due to events largely beyond our control.

Senator D'AMATO. I'm glad I insisted to my committee staff here that we not have Mr. Pickens at this session. I think it was a wise discretion on my part.

Senator CRANSTON. Are we having him?

Senator D'AMATO. Mr. Pickens will be at another session.

Mr. BRINEGAR. I would welcome an opportunity to debate this issue with him.

Senator D'AMATO. I'm sure you would.

Mr. BRINEGAR. This gap is due to events beyond our control. It's due to uncertainties in future oil prices and to the inflation of the past decade, and a worry over present and future prospects of Federal budget deficits. The appraised values upon which his arguments are based come from a report called Herold's Appraised Values that expressly states that they are not intended to be stock market values. And, as I show in attachment 3, the market behavior of companies that have been restructured—that is I think restructured, if I understand the definition— Mobil, Texaco, and Chevron—their behavior in the market in recent months has been poorer than companies that have not been restructured, such as Exxon, Standard of Indiana and Unocal. The companies that have been restructured are trading at about one-third of the so-called Herold's appraisal and the others are trading at half or more than half. So this gap is to me something that is beyond control of the management.

Thus, I believe that Mr. Pickens' restructuring idea does not stand the test of analysis and is revealed for what it is—a speculative scheme that takes advantage of the availability of easy money, the tax laws, and the avarice of short-term speculators.

NEED FOR A MORATORIUM

What is Congress' response? Well, there are three areas. First, I believe that there is an urgent need for a moratorium on hostile takeovers—a sort of cooling off period during which the Nation has a chance to pause and think about what's going on, the speculators are given notice that this chain letter can't go on forever, and Congress has a chance to make some needed legislative and regulatory changes. There are some bills being introduced, such as S. 473.

I think, second, the Tax Code should be revised to end the tax subsidies that encourage hostile takeovers. The major one is the ability to deduct interest on borrowed funds used in a hostile raid. In addition to disallowing the interest deduction, we believe that there should be special punitive taxes imposed on greenmail, that odious but often irresistible form of legal blackmail.

Third, I believe there is a legislative need to correct the general rules of the takeover game—so that we would have in the words of former SEC Commissioner Sommer, "A level playing field." And attachment 4 is an article by John Lawrence that discusses this.

There are bills that deal with these issues. There are also suggestions that have been made by Senators Chafee and Proxmire that perhaps something like a takeover impact statement may have to be considered to provide information to really understand the nature of the takeovers. We agree with this.

I believe also that Congress has an appropriate oversight role in raising the merger takeover and related issues with the proper Federal agencies, especially those that have regulatory responsibility for our financial system. Senator Proxmire, of this committee, when introducing S. 706, referred to this possibility. There are several regulatory agencies involved and I feel that there are many abuses for them to address.

In conclusion, let me stress that Unocal does not view America's oil industry as a sunset industry, as Mr. Pickens does, but rather as a place of opportunity—both for finding new sources of oil and gas and for developing alternative energy sources. Independent studies of our oil-finding record shows us to be among the industry's best. A recent study by Arthur Andersen found that Unocal's U.S. 1980–83 finding cost for oil and gas—converted to barrels—of $6.81 a barrel was the lowest of the 16 majors in the study. Mesa's finding cost for the same period, by contrast, was reported to be $14.82 per equivalent barrel.

Further, our record in geothermal energy and oil shale development shows us to be among the industry's most farsighted. In addition, our leadership in onshore and offshore exploration and in finding new ways to produce more oil from old oil fields means that, come the next energy crisis, Unocal expects to be at the front line in providing Americans with urgently needed petroleum products. Where, I might ask, will Mr. Pickens be at that time?

Mr. Chairman and members of the subcommittee, too many fine companies have already been murdered, or nearly so, by this speculative mania. I urge you to act before this entire industry has become disabled. Thank you.

[The complete prepared statement follows:]

STATEMENT BY

CLAUDE S. BRINEGAR

MR. CHAIRMAN AND SUBCOMMITTEE MEMBERS:

MY NAME IS CLAUDE S. BRINEGAR. I AM SENIOR VICE PRESIDENT AND MEMBER OF THE BOARD OF DIRECTORS OF UNOCAL CORPORATION. UNOCAL IS THE PARENT COMPANY OF UNION OIL COMPANY OF CALIFORNIA, ONE OF THE NATION'S REMAINING MAJOR INTEGRATED OIL COMPANIES. I AM APPEARING HERE TODAY ON BEHALF OF FRED L. HARTLEY, CHAIRMAN AND PRESIDENT OF UNOCAL. HE SENDS HIS REGRETS AND ASKED THAT I EXPRESS OUR APPRECIATION FOR THE OPPORTUNITY TO BE HERE TODAY TO DISCUSS SECURITIES, FINANCING AND OTHER ASPECTS OF MERGERS AND ACQUISITIONS, ESPECIALLY AS THEY RELATE TO THE OIL INDUSTRY.

WE ALL KNOW THAT MEMORIES ARE SHORT, BUT WE OFTEN FORGET HOW SHORT. NOT LONG AGO, PEOPLE TALKED OF AN "ENERGY CRISIS" AND URGED UNOCAL AND OTHER OIL COMPANIES TO STEP UP THEIR

INVESTMENTS IN EXPLORATION AND DEVELOPMENT AND TO MAKE LONG-TERM PLANS TO FIND ALTERNATIVE ENERGY SOURCES TO MEET AMERICA'S FUTURE NEEDS. NOT LONG BEFORE THAT, IN THE YEARS WHEN PEOPLE STILL REMEMBERED THE DEPRESSION, INDUSTRIAL COMPANIES (PARTICULARLY THOSE WITH HIGH FIXED COSTS) WERE URGED TO MAINTAIN "HEALTHY BALANCE SHEETS," WITH A HIGH RATIO OF EQUITY TO DEBT, SO THAT THEY COULD BETTER WITHSTAND CHANGES IN THE BUSINESS CLIMATE.

TODAY, OIL COMPANIES ARE RECEIVING A DIFFERENT MESSAGE, THIS TIME FROM TAKEOVER ARTISTS OR "RAIDERS." THE MESSAGE READS: "RESTRUCTURE" YOURSELF OR ELSE I'LL DO IT FOR YOU.

AND WHAT DOES "RESTRUCTURE" MEAN? AS FAR AS I CAN TELL IT MEANS ONE OF TWO THINGS: LIQUIDATION (E.G. GULF AND GETTY) OR A MASSIVE COVERSION OF EQUITY TO DEBT (E.G. PHILLIPS).

THIS "RAIDERS" GAME HAS BEEN PLAYED REPEATEDLY IN RECENT MONTHS, AND, INDEED, IS BEING PLAYED AT (OR WITH) UNOCAL THIS VERY MOMENT. THE FIRST STEP IS TO PUT A COMPANY "IN PLAY" BY BUYING A BLOCK OF STOCK, GENERALLY WITH BORROWED MONEY, AND MAKING A DRAMATIC ANNOUNCEMENT, SUCH AS A TAKEOVER PROPOSAL OR A "RESTRUCTURING" RECOMMENDATION. THE PROPOSAL MAY OR MAY NOT BE A SERIOUS ONE -- IT DOESN'T SEEM TO MATTER. MESA PETROLEUM, FOR EXAMPLE, HAS NOT ACTUALLY ACQUIRED ANY OF THE LARGE COMPANIES IT HAS THREATENED. BUT THE GAME HAS ENABLED MESA TO MAKE OVER A BILLION DOLLARS IN STOCK GAINS AND ANOTHER $100 MILLION IN SO-CALLED "EXPENSES".

INDEED, THE RAIDER HOPES THAT OTHER INVESTORS SEEKING "QUICK TURN" PROFIT WILL BUY STOCK IN THE EXPECTATION THAT "SOMETHING GOOD WILL HAPPEN." ONCE ENOUGH OF THE TARGET'S STOCK IS IN THE HANDS OF SHORT-TERM INVESTORS, THEIR EXPECTATIONS BECOME ACTION FORCING EVENTS: A BUYOUT FINANCED BY

HIGH-INTEREST "JUNK" BONDS; AN EXCHANGE OF DEBT FOR EQUITY; AND, FREQUENTLY, A HUGE "GREENMAIL" PAYMENT TO THE RAIDER, ENRICHING HIM WITH DOLLARS THAT WILL NOT GO EITHER INTO EXPLORATION OR TO SHAREHOLDERS.

SOME OF THE MOMENTUM BEHIND THE "TAKEOVER BUBBLE" COMES FROM SOURCES THAT THE CONGRESS CAN DO SOMETHING ABOUT ALMOST IMMEDIATELY. THE MOMENTUM COMES, FIRST OF ALL, FROM A FEDERALLY PROTECTED BANKING AND S & L ENVIRONMENT IN WHICH LOANS AT HIGH INTEREST RATES ARE SO ATTRACTIVE TO LENDERS THAT THE INSTITUTIONS RACE EACH OTHER TO PARTICIPATE. MOMENTUM COMES FROM THE FACT THAT GREENMAIL CAN BE DEMANDED AND RECEIVED BY RAIDERS, AND CAN BE PAID BY TARGETS, WITHOUT PENALTY. AND THE MOMENTUM COMES, FINALLY, FROM A TAX SYSTEM THAT FAVORS DEBT OVER EQUITY.

THE FULL EXTENT OF THE RECENT INDUSTRY TURMOIL CAN BE SEEN IN ATTACHMENT ONE, WHICH LISTS AMERICA'S MAJOR INTEGRATED

PETROLEUM COMPANIES AND THEIR DEBT RATIOS FIVE YEARS AGO AND TODAY. IN 1980, THERE WERE 15 MAJOR INTEGRATED COMPANIES -- ALMOST ALL WITH CONSERVATIVE DEBT BURDENS -- COMPETING WITH EACH OTHER IN EXPLORATION, PRODUCTION, REFINING AND MARKETING. BUT IN LESS THAN FIVE YEARS, FIVE OF THOSE COMPANIES HAVE DISAPPEARED AS INDEPENDENT ENTITIES AND FOUR OTHERS HAVE TAKEN ON LARGE DEBTS, INCLUDING PHILLIPS WHICH JUST LAST MONTH WAS FORCED TO TAKE ON A DEBT BURDEN OF RECORD PROPORTIONS.

UNOCAL HAS BECOME A RAIDER'S TARGET NOT BECAUSE WE ARE UNSUCCESSFUL, BUT RATHER BECAUSE WE HAVE BEEN SUCCESSFUL.

- WE HAVE BEEN SUCCESSFUL IN FINDING OIL AT LOW COST;

- WE HAVE BEEN MORE PROFITABLE THAN MOST OF OUR COMPETITORS AND HAVE PROVIDED BETTER RETURNS TO OUR SHAREHOLDERS;

o WE HAVE KEPT OUR DEBT BURDEN LOW SO THAT WE COULD INVEST AGGRESSIVELY TO FIND AND PRODUCE OIL AND IN THE DEVELOPMENT OF ALTERNATIVE ENERGY SOURCES NECESSARY TO OUR NATION'S FUTURE.

MR. CHAIRMAN, WHEN SUCCESS IN HARNESSING THE NATION'S ENERGY RESOURCES BRINGS ON THE DESTRUCTIVE RESULTS OF TAKEOVERS, THEN SOMETHING IS SERIOUSLY AMISS IN OUR NATION'S FINANCIAL AND TAX SYSTEM.

I REALIZE THAT SOME ECONOMISTS SUPPORT SUCH MOVES IN THE NAME OF "CAPITAL EFFICIENCY," BUT I BELIEVE THEY MISUNDERSTAND WHAT IS ACTUALLY GOING ON IN OUR INDUSTRY. IN PARTICULAR, I BELIEVE THEY FAIL MISUNDERSTAND FIVE KEY POINTS WITH POSSIBLE ADVERSE IMPACTS ON THE NATION:

1. THE DISAPPEARANCE OF SO MANY MAJOR COMPETITORS WILL LEAD TO A CONCENTRATED INDUSTRY DOMINATED BY A FEW GIANTS --

AND TO ONE THAT, AS IN THE EARLY 1970'S, IS DEPENDENT UPON THE WHIMS OF FOREIGN OIL PRODUCERS. OTHER INDUSTRIES HAVE FOLLOWED THIS PATTERN (E.G., AUTOS AND STEEL) AND THEY HAVE TENDED TO BECOME BUREAUCRATIC, INEFFICIENT, AND SHORT ON INNOVATIVE DRIVE -- AND HAVE FOUND THEMSELVES AT THE MERCY OF FOREIGN COMPETITORS.

THIS LAST POINT IS ESPECIALLY IMPORTANT. IF THE OIL INDUSTRY IS GOING TO BE SUCCESSFUL IN EXPLORING AMERICA'S FRONTIER REGIONS -- PARTICULARLY IN ALASKA AND IN DEEP OFFSHORE WATERS -- AND ALSO DEVELOP NEEDED ALTERNATIVE ENERGY SOURCES, SUCH AS OIL SHALE, IT WILL NEED ALL THE CREATIVITY AND ENTREPRENEURSHIP IT CAN MUSTER. IN SHORT, IT WILL NEED AS MANY STRONG COMPETITORS AS THE NATION CAN POSSIBLY SUPPORT.

2. EVEN WHEN IT IS UNSUCCESSFUL, THE THREATENED TAKEOVER OF A LARGE COMPANY FORCES MANAGEMENT TO FOCUS ON SHORT-TERM RESULTS AND DEFENSIVE TACTICS. EXPLORATION, RESEARCH AND

DEVELOPMENT, LONG-TERM PLANNING, AND EVEN RATIONAL DECISIONMAKING ARE VICTIMS OF THE RAID. SENATOR PROXMIRE'S EXCELLENT STATEMENT WHEN HE INTRODUCED S. 706, THE CORPORATE PRODUCTIVITY ACT OF 1985, QUOTED ON THIS POINT FROM PETER DRUCKER'S WALL STREET JOURNAL ARTICLE (October 30, 1984). I CAN ATTEST PERSONALLY TO THE CORRECTNESS OF MR. DRUCKER'S VIEWS.

3. RECENT WALL STREET JOURNAL, FORBES AND HARPER'S ARTICLES HAVE DESCRIBED "JUNK FINANCING," WHICH HAS BECOME THE TOOL USED TO FINANCE RAIDS AND FORCE GREENMAIL BUYOUTS. THE FORBES ARTICLE WAS TITLED "TAKING IN EACH OTHER'S LAUNDRY", AND REPEATEDLY DESCRIBED TRANSACTIONS AS "ONE HAND WASHING THE OTHER," "THE JUNK TAKEOVER," AND "THE OLD STORY OF THE $50,000 DOG PAID FOR BY TWO $25,000 CATS."

HARPER'S DESCRIBED HOW DREXEL FINANCED MESA'S GULF RAID WITH OVER $2 BILLION IN JUNK IN A FICTITIOUS COMPANY THAT "WOULD PRODUCE NOTHING, ERECT NO EDIFICES, AND LEAVE ONLY ONE TRACE OF ITS PASSAGE: IT WOULD MURDER ANOTHER COMPANY. . ."

4. SUBSTANTIAL INCREASES IN DEBT, INCURRED EITHER TO FINANCE AN ACQUISITION (E.G., CHEVRON) OR TO DEFEND AGAINST ONE (E.G., PHILLIPS), ARE NOT HEALTHY IN AN INDUSTRY THAT HAS HIGH FIXED COSTS AND IS VULNERABLE TO PRICE SWINGS DUE TO FORCES BEYOND ITS CONTROL. COMPANIES BURDENED WITH EXCESSIVE DEBT SERVICE LACK THE CASH FOR AGGRESSIVE EXPLORATION AND INNOVATION. COMPANIES WITHOUT BORROWING CAPACITY MAY BE UNABLE TO MAKE NEEDED EXPENDITURES FOR EXPANSION. COMPANIES WITH EXCESSIVE DEBT ARE LIABLE TO FAILURE AND PRONE TO AVOID RISKS.

THIS POINT WAS WELL MADE RECENTLY BY S.E.C. CHAIRMAN SHAD:

> "CORPORATE TAKEOVERS AND BUYOUTS ARE FINANCED THROUGH LARGE LOANS. THE NET EFFECT IS THAT DEBT IS BEING USED TO RETIRE EQUITY, WHICH IS KNOWN AS LEVERAGING UP A COMPANY'S CAPITALIZATION. THE GREATER THE LEVERAGE, THE GREATER THE RISKS TO

THE COMPANY, ITS SHAREHOLDERS, CREDITORS, OFFICERS, EMPLOYEES, SUPPLIERS, CUSTOMERS, AND OTHERS .... THE MORE LEVERAGED TAKEOVERS AND BUYOUTS TODAY, THE MORE BANKRUPTCIES TOMORROW."

5. THE NATION'S BANKING, S&L, AND SECURITIES FIRMS ARE GREATLY OVEREXTENDING THEMSELVES BY FINANCING HIGHLY-LEVERAGED, MULTI-BILLION DOLLAR OIL COMPANY TAKEOVERS. A RECENT FORBES ARTICLE, "AN IDEA WHOSE TIME HAS GONE" DISCUSSES THE NEW PHENOMENON OF S&L'S "FINANCING GREENMAIL AND STOCK SPECULATION" AS WELL AS REAL ESTATE SPECULATION. FORBES SAYS "THAT'S POTENTIALLY VERY LUCRATIVE BUT EXCEPTIONALLY RISKY, ESPECIALLY FOR S&L'S ALREADY IN SUCH WEAKENED CONDITION THAT THEY HAVE VERY LITTLE CAPITAL LEFT TO LOSE."

CLEARLY, BANKS, S&L'S AND SECURITIES FIRMS SHOULD BE CONCENTRATING MORE ON SOLID LOANS THAN ON MANY OF THESE

TPANSACTIONS. THEY SHOULD GRANT LOANS THAT CREATE JOBS, BUILD HOUSES, AND ADD TO THE NATION'S REAL WEALTH, NOT LOANS THAT BENEFIT ONLY SPECULATORS, TAKEOVER ARTISTS, AND THEIR LAWYERS. A FURTHER MAJOR DROP IN WORLD OIL PRICES, COUPLED WITH AN INCREASE IN HIGH INTEREST RATES -- NOT UNLIKELY EVENTS -- COULD THROW MANY OF THESE HIGH-INTEREST, LOW-SECURITY "JUNK" LOANS INTO DEFAULT OR "WORKOUT" STATUS. THAT COULD PUSH MANY LARGE BANKS AND S&L'S TO THE BRINK OF FAILURE, FORCING A NEW ROUND OF FEDERAL BAIL-OUTS.

HENRY KAUFMAN OF SALOMON BROTHERS HAS POINTED OUT THAT SUCH DEALS REMOVED BETWEEN $80 BILLION AND $90 BILLION OF EQUITY SECURITIES FROM THE U.S. MARKETPLACE IN 1984 ALONE -- MORE THAN 4 PERCENT OF THE TOTAL VALUE OF ALL U.S. STOCKS.

NOW, LET'S TURN TO MY INDUSTRY AND ASK: WHY IS THIS ESPECIALLY HAPPENING TO LARGE OIL COMPANIES?

FIRST, LET ME DISCUSS WHAT IS NOT THE CAUSE: IT IS NOT BECAUSE THIS ENTIRE GROUP OF U.S. INTEGRATED OIL COMPANIES SOMEHOW, SUDDENLY NEEDS TO BE "RESTRUCTURED," THOUGH THIS IS THE CLAIM OF MR. PICKENS (SEE HIS FEBRUARY 27 TESTIMONY BEFORE HOUSE COMMITTEE -- ATTACHMENT TWO). IF WE CARRY HIS LINE OF REASONING TO ITS EXTREME, EVERY COMPANY LISTED IN EXHIBIT ONE EITHER WOULD BE MERGED, LIQUIDATED, OR "DECAPITALIZED" (THAT IS, FORCED INTO A MASSIVE CONVERSION OF EQUITY TO DEBT, A'LA PHILLIPS). THIS IS OBVIOUSLY AN IMPOSSIBLE RESULT WITH IMPOSSIBLE DEMANDS ON THE CREDIT SYSTEM; BUT IT IS ALSO A RESULT THAT, EVEN IF PARTLY ACHIEVED, WOULD CRIPPLE AN ESSENTIAL INDUSTRY.

AS EUGENE NOWAK, AN OIL ANALYST AT DEAN WITTER, SAID IN A RECENT WASHINGTON POST ARTICLE:

"(THIS RESTRUCTURING IS FORCING) A STRONG ORIENTATION (TOWARD) SHORT-TERM PERFORMANCE AND REWARDS AT THE PERIL OF DRAMATICALLY REDUCING FUTURE BENEFITS....

"IF IT CONTINUES, I THINK THERE ARE DIRE CONSEQUENCES FOR THE LONG-TERM ENERGY SUPPLIES OF THE UNITED STATES, AND PERHAPS (THE TREND COULD BRING) ON AN ENERGY CRISIS SOONER, RATHER THAN LATER."

NOW, LET ME SHIFT TO A DISCUSSION OF WHAT I THINK IS THE CAUSE OF THIS PHENOMENON. I BELIEVE THIS WAVE OF MERGERS AND TAKEOVERS IS HAPPENING:

1. BECAUSE ENORMOUS AMOUNTS OF MONEY HAVE BECOME AVAILABLE FOR SPECULATIVE SHORT-TERM DEALS AS A RESULT OF THE MOVE TO "DEREGULATE" FINANCIAL INSTITUTIONS; SOME OF

THOSE INSTITUTIONS ARE NOW ACTING FOOLISHLY, CONSIDERING THEIR RESPONSIBILITIES. THEY ARE BUYING HIGH-RISK DEBT AND HOPING IT WILL ALL WORK OUT.

2. BECAUSE, WITH THE EMERGENCE OF JUNK FINANCING, BIDDERS CAN "BORROW" 100 PERCENT OF THE COST OF AN ACQUISITION IN ADVANCE, WITH LITTLE OR NO SECURITY, ON THE PROMISE THAT THEY WILL BUST UP THE TARGET TO REPAY THE LOAN. THEY MAY NOT ACTUALLY BORROW THE MONEY, BUT IT GIVES THEM THEIR ABILITY TO THREATEN TARGETS MANY TIMES THEIR SIZE.

A RELATED ABUSE OF FINANCIAL POWER IS THE PAYMENT OF OUTRAGEOUS COMMITMENT FEES TO FINANCIAL INSTITUTIONS BY RAIDERS AND GREENMAILERS WHO HAVE THEREBY OBTAINED A FACADE OF FINANCING FOR THEIR TENDER OFFERS. THROUGH SUCH COMMITMENT PAYMENTS, WHICH SUPPOSEDLY ASSURE THE BORROWER OF POSSIBLE FINANCING, A RAIDER OR GREENMAILER CONVEYS TO

THE PUBLIC THE IMPRESSION THAT HE CAN FINANCE AN OFFER, FANNING SPECULATION IN THE MARKETPLACE AND OFTEN STAMPEDING MANAGEMENT INTO A BUYOUT OR SOME OTHER PRECIPITOUS ACTION.

IN SOME INSTANCES IT IS QUESTIONABLE WHETHER THE INSTITUTION BEING PAID THE COMMITMENT FEE HAS CAREFULLY SCRUTINIZED THE IMPLICATIONS OF THE LOAN THAT IT IS UNDERTAKING TO GUARANTEE. AND THERE CAN BE A VERY REAL QUESTION WHETHER THE INSTITUTION ISN'T SIMPLY GAMBLING THAT THE LOAN WILL NEVER BE TAKEN UP. OR IS THE INSTITUTION BEING SWAYED BY THE COMMITMENT FEE INTO OVERREACHING ON A RISKY LOAN? IS IT A PROPER FUNCTION OF BANKS AND FINANCIAL INSTITUTIONS TO ACT AS ACCOMPLICES IN CORPORATE EXTORTION?;

3. BECAUSE THE TAX SYSTEM, WHICH PERMITS THE DEDUCTION OF INTEREST ON BORROWED MONEY USED FOR

SUCCESSFUL, UNSUCCESSFUL OR EVEN THREATENED RAIDING, FAVORS DEBT OVER EQUITY; BECAUSE IT ALLOWS THESE COMMITMENT FEES TO BE TREATED AS BUSINESS EXPENSES; AND BECAUSE IT FAVORS THE SO-CALLED "INVESTOR" OVER THE BUSINESSMAN -- THE RAIDER OVER THE DEFENDER;

4. BECAUSE OF THE EMERGENCE OF A GROUP OF PROFESSIONAL RAIDERS, WHOSE INTEREST IS NOT IN THE OVERALL HEALTH OF THE ECONOMY OR IN HELPING TRUE SHAREHOLDERS, BUT ONLY IN MAKING "QUICK-TURN" PROFITS FOR THEMSELVES. I NEED NOT LIST THEM HERE -- THEY HAVE ALL BEEN GLAMORIZED RECENTLY IN ARTICLES IN TIME, FORTUNE, BUSINESS WEEK, HARPERS AND ELSEWHERE. THEY ARE BECOMING ALMOST HOUSEHOLD NAMES; AND

5. BECAUSE, IN THE CASE OF THE OIL INDUSTRY, MR. PICKENS HAS SOMEHOW CREATED A SPECULATIVE FRENZY -- HIS MODERN VERSION OF THE SOUTH SEA BUBBLE -- THAT HAS

CONVINCED MANY ON WALL STREET THAT "THERE'S EASY MONEY TO BE MADE IN ATTACKING OIL COMPANIES, AND TO HELL WITH TOMORROW." BUT THIS BUBBLE -- LIKE ALL BUBBLES -- WILL EVENTUALLY COLLAPSE, AND WHEN IT DOES IT WILL LEAVE BEHIND THE WRECKAGE OF RUINED COMPANIES, LOST JOBS, REDUCED U.S. OIL PRODUCTION, FAILED BANKS AND S&L'S, AND GOVERNMENT BAIL-OUTS.

LEST YOU THINK I'M EXAGGERATING WHEN I SAY THAT MR. PICKENS FAVORS THE "RESTRUCTURING" OF JUST ABOUT EVERYONE (EXCEPT, OF COURSE, MESA, WHICH IS SURROUNDED BY SEVERAL LAYERS OF SHARK REPELLENT), LET ME OFFER SOME EVIDENCE.

ATTACHMENT TWO IS AN EXCERPT FROM HIS STATEMENT BEFORE A HOUSE COMMITTEE ON FEBRUARY 27. THE TABLE LISTS EIGHT MAJOR COMPANIES BY NAME AND SHOWS A "GAP" IN VALUE THAT HIS SO-CALLED "RESTRUCTURING" OR HIS BETTER MANAGEMENT WOULD CLOSE. BUT MR. PICKENS' ARGUMENT IS WRONG -- THE

GAP IS DUE TO EVENTS LARGELY BEYOND OUR CONTROL -- TO UNCERTAINTIES IN FUTURE OIL PRICES AND TO THE INFLATION OF THE PAST DECADE. THE APPRAISED VALUES ON WHICH HIS ARGUMENTS ARE BASED COME FROM A REPORT ("HEROLD'S APPRAISED VALUES") THAT EXPRESSLY STATES THAT THEY ARE NOT INTENDED TO BE STOCK MARKET VALUES. AND, AS ATTACHMENT THREE SHOWS, THE RELATIVE MARKET BEHAVIOR -- THAT IS, MARKET PRICE AS A PERCENT OF HEROLD'S APPRAISED VALUE -- OF THE COMPANIES THAT HAVE "RESTRUCTURED" THEMSELVES IN RECENT MONTHS (TEXACO, MOBIL, AND CHEVRON) IS POORER THAN THAT OF THE COMPANIES THAT HAVE NOT (EXXON, STANDARD OF INDIANA, AND UNOCAL).

THUS, HIS "RESTRUCTURING" IDEA DOES NOT STAND THE TEST OF ANALYSIS, AND IS REVEALED FOR WHAT IT IS: A SPECULATIVE SCHEME THAT TAKES ADVANTAGE OF THE AVAILABILITY OF EASY MONEY, THE TAX LAWS, AND THE AVARICE OF SHORT-TERM SPECULATORS.

WHAT IS CONGRESS' APPROPRIATE RESPONSE TO THIS "RAIDING-RESTRUCTURING" MANIA?

WE URGE ACTION IN THESE AREAS:

1. THE MOST URGENT NEED IS FOR A MORATORIUM ON HOSTILE TAKEOVERS -- A SORT OF "COOLING OFF" PERIOD DURING WHICH THE NATION HAS A CHANCE TO PAUSE AND THINK ABOUT WHAT'S GOING ON, THE SPECULATORS ARE GIVEN NOTICE THAT THIS CHAIN LETTER CAN'T GO ON FOREVER, AND CONGRESS HAS A CHANCE TO MAKE SOME NEEDED LEGISLATIVE AND REGULATORY CHANGES. S. 473 AND VARIOUS HOUSE BILLS CALL FOR SUCH A MORATORIUM.

2. THE TAX CODE SHOULD BE REVISED TO END THE TAX SUBSIDIES THAT ENCOURAGE HOSTILE TAKEOVERS. THE MAJOR ONE IS THE ABILITY TO DEDUCT INTEREST ON BORROWED

FUNDS USED IN A HOSTILE RAID. IN ADDITION TO DISALLOWING THE INTEREST DEDUCTION, UNOCAL BELIEVES THERE SHOULD BE SPECIAL PUNITIVE TAXES IMPOSED ON "GREENMAIL", THAT ODIOUS BUT OFTEN IRRESISTIBLE FORM OF LEGAL BLACKMAIL. S. 286, S. 420, S. 476, S. 414, AND S. 632 ARE BILLS THAT DEAL WITH THESE ISSUES.

3. THERE IS ALSO A LEGISLATIVE NEED TO CORRECT THE GENERAL RULES OF THE TAKEOVER GAME -- SO THAT WE WOULD HAVE, IN THE WORDS OF FORMER S.E.C. COMMISSIONER SOMMER: "...A LEVEL PLAYING FIELD." ATTACHMENT FOUR, AN ARTICLE BY JOHN F. LAWRENCE FROM THE LOS ANGELES TIMES FOR FEBRUARY 17, 1985, TITLED "MARKET RULES FAVOR RAIDERS, ALLOW ABUSES," SPEAKS IN SOME DETAIL TO THESE MATTERS.

S. 631, S. 706 AND CORRESPONDING HOUSE BILLS DEAL WITH ISSUES OF THIS NATURE. FOR EXAMPLE, THE QUESTION OF

WHETHER OR NOT TO DO ANYTHING ABOUT A HOSTILE TAKEOVER SHOULD BE BASED ON PROPER INFORMATION. BOTH SENATOR CHAFEE AND SENATOR PROXMIRE HAVE SUGGESTED SOMETHING LIKE A "TAKFOVER IMPACT STATEMENT" TO PROVIDE THAT INFORMATION. WE AGREE.

I ALSO BELIEVE CONGRESS HAS AN APPROPRIATE OVERSIGHT ROLE IN RAISING THE MERGER-TAKEOVER AND RELATED ISSUES WITH THE PROPER FEDERAL AGENCIES, ESPECIALLY THOSE THAT HAVE REGULATORY RESPONSIBILITY FOR OUR FINANCIAL SYSTEM. SENATOR PROXMIRE, OF THIS COMMITTEE, WHEN INTRODUCING S. 706 (THE CORPORATE PRODUCTIVITY ACT OF 1985) REFERRED TO THAT POSSIBILITY. THERE ARE SEVERAL REGULATORY AGENCIES INVOLVED, AND I FEEL THAT THERE ARE MANY ABUSES FOR THEM TO ADDRESS.

IN CONCLUSION, LET ME STRESS THAT UNOCAL DOES NOT VIEW AMERICA'S OIL INDUSTRY AS A SUNSET INDUSTRY, AS MR. PICKENS DOES, BUT RATHER AS A PLACE OF OPPORTUNITY -- BOTH FOR FINDING NEW SOURCES OF OIL AND GAS AND FOR DEVELOPING ALTERNATIVE ENERGY SOURCES. INDEPENDENT STUDIES OF OUR OIL-FINDING RECORD SHOWS US TO BE AMONG THE INDUSTRY'S BEST: A RECENT STUDY BY ARTHUR ANDERSEN & COMPANY FOUND THAT UNOCAL'S U.S. 1980-1983 FINDING COST FOR OIL AND GAS (CONVERTED TO EQUIVALENT BARRELS) OF $6.82 A BARREL WAS THE LOWEST OF THE 16 MAJORS IN THE STUDY. MESA'S FINDING COST FOR THE SAME PERIOD, BY CONTRAST, WAS REPORTED TO BE $14.82 PER EQUIVALENT BARREL.

FURTHER, OUR RECORD IN GEOTHERMAL ENERGY AND OIL SHALE DEVELOPMENT SHOWS US TO BE AMONG THE INDUSTRY'S MOST FARSIGHTED. IN ADDITION, OUR LEADERSHIP IN ONSHORE AND OFFSHORE EXPLORATION AND IN FINDING NEW WAYS TO PRODUCE MORE OIL FROM OLD OIL FIELDS MEANS THAT, COME THE NEXT

ENERGY CRISIS, UNOCAL EXPECTS TO BE AT THE FRONT LINE IN PROVIDING AMERICANS WITH URGENTLY NEEDED PETROLEUM PRODUCTS. WHERE, I MIGHT ASK, WILL MR. PICKENS BE AT THAT TIME?

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, TOO MANY FINE COMPANIES HAVE ALREADY BEEN MURDERED, OR NEARLY SO, BY THIS SPECULATIVE MANIA. I URGE YOU TO ACT BEFORE THIS ENTIRE INDUSTRY HAS BECOME DISABLED.

THANK YOU.

50-673 O—85——4

ATTACHMENT ONE

MAJOR U.S. INTEGRATED PETROLEUM COMPANIES
1980 AND 1985

January 1, 1980	Debt Ratio %	January 1, 1985	Debt Ratio %
Atlantic Richfield	33.9	Atlantic Richfield	27.9
Chevron (formerly Standard of Calif.)	18.1	Chevron	46.8
Cities Service	31.8	(Merged into Occidental and then broken up)	-
Continental	30.0	(Merged into DuPont)	-
Exxon	15.9	Exxon	13.3
Getty	4.7	(Merged into Texaco)	-
Gulf	15.1	(Merged into Chevron)	-
Marathon	40.0	(Merged into U.S. Steel)	-
Mobil	23.9	Mobil	46.2
Phillips	14.9	Phillips	80(e)
Shell	33.8	Shell (now 100% owned by Royal Dutch)	-
Standard of Ohio	55.3	Standard of Ohio (now 53% owned by British Petroleum)	-
Sun	17.4	Sun	30.2
Texaco	24.5	Texaco	44.2
Unocal (formerly Union Oil Co. of Calif.)	29.2	Unocal	18.2

ATTACMENT TWO

. . . .

Simply put, shareholders are not realizing the true value from their investment. This is especially reflected in the major oil companies' appraised value versus market value. Here are some examples:

	John S. Herold Appraised Value	Market Value 2-25-85
Exxon	$63 billion	$38 billion
Arco	$31 billion	$12 billion
Chevron	$37 billion	$12 billion
Texaco	$24 billion	$ 9 billion
Mobil	$36 billion	$12 billion
Sun	$10 billion	$ 6 billion
Unocal	$13 billion	$ 8 billion
Std. Ind.	$31 billion	$17 billion

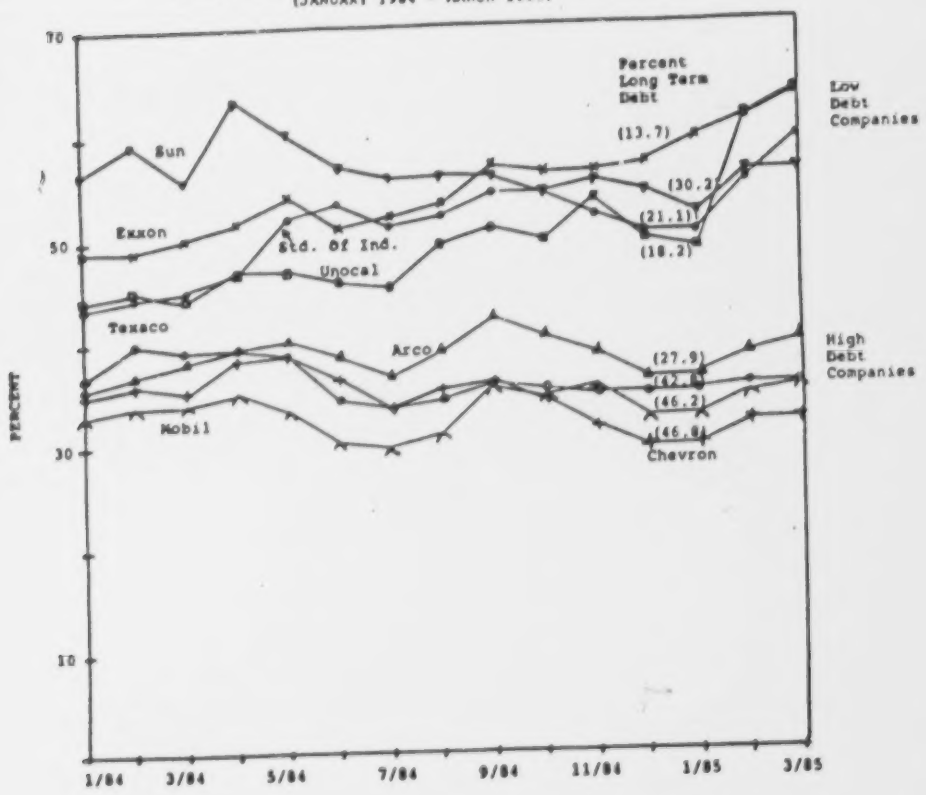
These companies must find a way to get their market value closer to appraised value. That is the challenge for these managements.

It should surprise no one that, in some instances, large stockholders have taken it upon themselves to force management to take action. That is what occurred at Getty, Gulf and Superior, and in such cases shareholder wealth increased. If management is unwilling to allow shareholders the opportunity to benefit from the untapped value of the company's assets, it is time for a change.

Excerpt from pp 11-12 of T. Boone Pickens' testimony 2-27-85 before the House Committee on Energy and Commerce - Subcommittee on Telecommunications, Consumer Protection and Finance.

ATTACHMENT THREE

MARKET VALUE AS A PERCENT OF HEROLD'S APPRAISED VALUE
(JANUARY 1984 - MARCH 1985)



Note: Herold's appraised value is calculated by adding estimated values for all of a company's assets and subtracting its long-term liabilities.

ATTACHMENT FOUR

Los Angeles Times, February 17, 1985

JOHN F. LAWRENCE

Market Rules Favor Raiders, Allow Abuses

Amid the desultory attempts to find a solution to the takeover binge, not much has been said about one of the most basic causes—the vast transformation of the stock market.

Put simply, the market has changed from a public marketplace, where the players are all essentially equal, to a professionals' market, overwhelmingly dominated by the trading of a relatively few managers of very large funds.

Essentially, it is this change that has made corporate raiding easy. Professionals can react quickly enough and with significant enough blocks of stock to make the market serve the raiders' purposes, giving them the inside track.

To date, much of the regulatory effort has been aimed at the way corporations seek to defend against the raids. As usual, the Securities and Exchange Commission and the stock exchanges are hung up on some supposed threat to the free market if they put any impediment in the way of corporate takeovers. They have yet to recognize that takeovers themselves are a major threat to the market.

Unequal Treatment

Financier Felix Rohatyn put it succinctly in congressional testimony last year when he said that "tactics used in corporate takeovers . . . create massive transactions that greatly benefit lawyers, investment bankers and arbitrageurs, but often result in weaker companies and do not treat all shareholders equally and fairly."

He added: "I believe we are reaching the point where the integrity of our financial markets is in question and, after all, that has been the basis of our free enterprise system."

Former SEC commissioner A. A. Sommer Jr. speaks of four myths impeding reform.

- That there is a level playing field. Instead, current policy and the nature of the market tilt the game strongly in favor of the raiders.
- That takeovers are good because they boost the target's stock price. This notion ignores how the raiding company's stockholders fare or what the net impact is on companies and the economy.
- That takeovers are needed to root out bad management. It appears that well-run companies are targets as often as not.
- That takeovers assure the most efficient use of corporate resources. Evidence points in the opposite direction. Companies that have been taken over often end up weaker and perform poorly; they wind up with more debt and less permanent capital.

If the market is to continue to attract investment from individuals, then it must be a public market where liquidity—the ability to buy and sell at a relatively stable price—is maintained by an abundance of participants. It should not be the vehicle for professionals to seek substantial influence or control over the affairs of companies.

There would remain ample opportunity for seeking corporate control through agreements reached with management and directors or through a proxy contest, where the attacking group can seek shareholder votes on the merit of the management skills it can bring to the company. That's where the focus belongs, not on offers of quick profit in the stock market.

By permitting professionals to misuse the market, the government and the exchanges are permitting a major distortion of market price-setting. In the past, regulation, even if belatedly, has sought to correct such abuses. After the manipulative practices of the 1920s contributed to the market's collapse, such things as secret investment pools and deliberate camouflaging of trading were outlawed. The speculative excesses of the late 1960s led to further reforms, though once again not before another major collapse.

Today's abuses may not be manipulation in the classic sense. However, raiders are permitted to amass huge positions before disclosure rules take effect and other investors know their true purpose. Because corporations sometimes pay them to back off, raiders often assure themselves of profit whether or not they capture their targets. With the potential takeover aborted, individual investors end up watching the stock plummet.

The time has come to focus on bringing regulation of the market into line with current problems.

John F. Lawrence is The Times' economic affairs editor.

Senator D'AMATO. Thank you, Mr. Brinegar.
Mr. Bradley.

STATEMENT OF MICHAEL BRADLEY, PROFESSOR, GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF MICHIGAN, ANN ARBOR, MI

Mr. BRADLEY. Thank you, Senator D'Amato.

This morning I would like to review the scientific evidence concerning the economic effects of corporate acquisitions by tender offer.

My purpose is to inject the available scientific evidence into the debate over the proper role of Government regulation of this capital market transaction.

Indeed, my hope is that this evidence will become the focal point of your deliberations.

It seems rather obvious that an accurate assessment of current or proposed regulations must be predicated on a sound understanding of the facts.

An understanding of the economic consequences of acquisitions by tender offer, under the current regulatory regime, seems an essential first step in formulating new regulations.

Relatedly, I think that it is incumbent on those who advocate a change in the status quo to show that there is something wrong with the current system: specifically, they should be forced to demonstrate that under current regulations, unnegotiated tender offers reduce social welfare.

Those who propose reforms without sufficient evidence would do well to heed the admonition: "If it ain't broke, don't fix it."

Don't create elaborate regulatory solutions to problems that don't exist.

More to the point, the available scientific evidence indicates that many of the alleged problems with the current system just do not exist.

Indeed, my message to you this morning is that the tender offer mechanism "ain't broke, and therefore, it doesn't need fixing"—particularly the kind of fixing that would strengthen the position of the managers of target firms.

GAINS OVER $35 BILLION

While contrary anecdotal evidence abounds, the virtually unanimous conclusion among financial economists is that corporate acquisitions by tender offer channel corporate resources to higher valued uses. The 183 acquisitions by tender offer involving New York and American Stock Exchange firms between 1962 and 1980 created over $5.75 billion in new corporate wealth. And the total gains to the stockholders of the 136 listed targets acquired by tender offer over the period 1981–1984 was over $35 billion.

Clearly, unnegotiated tender offers create value and hence are welfare-increasing transactions.

While there is some controversy concerning the gains to acquiring firms, there is none regarding the significant capital gains realized by the stockholders of target firms or the fact that corporate combinations by tender offer on net create economic value.

Most of the data that I will be referring to this morning are derived from my own research and research conducted with my colleagues, E. Han Kim and Anand Desai, of the University of Michigan.

However, almost identical evidence with the same interpretation and implications can be found throughout the literature of financial economics.

The empirical effects of corporate acquisitions have been an important research topic of financial economists for many years.

In fact, I know of no other corporate event that has been more analyzed, more scrutinized by more junior faculty and Ph.D. students with more computer dollars than corporate acquisitions.

The main thrust of this research has centered around one basic issue: Do corporate acquisitions in general and tender offers in particular, channel corporate resources to higher valued uses or do they simply redistribute wealth from one stockholder group to another—and if the latter, in which direction does the wealth transfer flow?

Obviously, in order to answer these and related questions, one must first develop an appropriate measure of firm value. Fortunately, financial economists resolved this very important issue long ago.

The virtually unanimous consensus within the profession is that the market price of a firm's securities is the best indicator of its economic value.

EFFICIENT MARKET HYPOTHESIS

The almost exclusive reliance on capital market data by financial economists stems in part from the obvious deficiencies of alternative measures—measures based on accounting numbers, sales figures or production data.

However, the major reason for the widespread use of capital market data to measure the value of a corporation is the almost universal acceptance of the efficient market hypothesis. The efficient market hypothesis simply states that at any point in time security prices reflect all publicly available information.

Prof. Michael Jensen, the founding editor of the Journal of Financial Economics, our leading professional journal, has stated that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Capital Market Hypothesis."

The hypothesis has been tested and retested across many different securities markets and in regard to literally hundreds of economic events. And with very few exceptions, the data show that capital market prices do in fact reflect all publicly available information; that investors cannot profitably trade on what they read in the newspaper or in annual reports; that stock prices are unbiased estimates of future, long-term equity values.

As a result of these and other considerations, the bulk of the evidence that I will be discussing this morning is based on security market returns.

However, before I turn to the evidence, I want to spend a little time reviewing the mechanics of a two-tier tender offer. I think it

will be useful for you to see how economists view this capital market transaction so that you can in turn appreciate how and why we reach the conclusions we do, given the available data.

On page 1 of the exhibits to accompany my testimony, I have defined the important parameters of a two-tier tender offer and if you have that before you I would like you to turn to page 1 of the exhibits which accompany my testimony.

On page 1, I define the four parameters of a two-tier tender offer. First, is the fraction of target shares sought by the bidding firm. Second, is the preannouncement market price of a target share. This preannouncement market price is used as a benchmark in measuring the wealth effect of acquisitions on target stockholders.

P_T is the front end of the offer price and is the price paid for the fraction of shares purchased in the first step of the acquisition. P_E is the back end offer price. It is the price paid for 1 minus F of the target shares purchased in the second step of the acquisition.

On page 2 of the handout, it shows the market pricing of a share of a target of a successful tender offer. The post-announcement but preexecution market price with full subscription and pro rata execution is given by that equation. The equation is simply the blended premium that we've seen on Wall Street where the front end is weighed by the fraction of shares purchased in the high end and the back end of the offers weighted by the fraction of shares purchased in the back end.

As an illustration of this pricing mechanism, I have before you the parameters of the United States Steel Corp's acquisition of Marathon. The preannouncement market price was running between $50 and $60. United States Steel Corp., on November 19, 1981, made a bid for 51 percent of Marathon stock for a front-end price of $125, a back-end price value of $90 by market analysts. The expected price after the announcement of this offer is $107.85, according to that above equation, and indeed on November 20, 1981, the day after the announcement, the shares of Marathon were trading for $107.25. It's clear the market understands the parameters of the tender offer and is capable of efficiently pricing that transaction.

On page 3, I show what I consider to be the necessary conditions for a successful tender offer. It's been discussed already in opening statements and it is the notion that the front end of the tender offer must be higher than the back end of the tender offer; namely, that all successful tender offers are necessarily front-end loaded.

Some critics of the tender offer mechanism argue that front-end loaded, two-tier tender offers are coercive. An economist, rather, would say that they are necessary in order to induce rational, wealth-maximizing target stockholders to tender their shares.

The typical tender in relation to the parameters is given on the bottom of page 3. The tender offer price, the front-end price, P_T, is significantly greater than the preannouncement level, P_O. P_A is the blended price between the two front ends of the offer, P_T and P_E. And more importantly, P_E typically is higher than the preannouncement price. In other words, there's a significant premium paid even on the back end of the offer.

To illustrate the front-end and back-end mechanism, I refer you to page 4 which is the result of a study done by the Securities and Exchange Commission, Office of the Chief Economist.

In that table we see of the 38 two-tier tender offers effected between 1981 and 1984 the front-end premium was 64 percent, the back-end premium 46 percent, with a blended premium of 55.3. Let me underscore the fact that with pro rata execution and all target stockholders tendering, the target stockholders will all share in this premium. They will all receive an average premium of 55.3, 64 on the front end, 46 percent on the back end.

RESULTS OF SUCCESSFUL TENDER OFFERS

On page 5, I show the results of the returns to 103 targets of successful tender offers involved in tender offers over the period 1962–80. We see very clearly that there's a significant capital gain realized by the stockholders of target firms: In multiple bidder contests, 43 percent; single bidder contest, 25 percent. I should point out that although these data only run to 1980 and are for 80 days reported here, subsequent research has taken those returns out for 5 years and there is no significant difference in this 30 percent. In other words, while I only show 80 days, this is indeed a long-run effect.

On page 6, I show the returns to acquiring firms. We see that on average acquiring firms, while realizing a positive return, do not realize the rate of return that the target stockholders do. Again, I show the difference between single and multiple bidders and clearly we see that with multiple bidder contests, target stockholders gain more with the stockholders of acquiring firms gaining relatively less.

On page 7, I turn those rates of returns into dollar amounts and we see that the 183 New York and American Stock Exchange firms involved in tender offers over the indicated period, target stockholders realized $5 billion in net increase in net worth; acquirers $1 billion. The combined revaluation of these assets is on the order of $6 billion.

On page 8, I've updated the data with the help of again the Securities and Exchange Commission, the Office of the Chief Economist. Here we look at the premiums paid to 136 targets in two-tier offers from 1981–84. Again, we see huge economic gains to the targets. The targets here realized a total increase in value—this is increase above the preannouncement level—of $35 billion.

In table 9 I split the returns to targets between two time periods—one, 1962–69; the other, 1970–82. We see the target stockholders clearly have increased their returns over the latter period.

Similarly, or perhaps conversely, on page 10, I show that the rate of return to acquiring firms has significantly decreased over this period.

The two graphs on pages 9 and 10 clearly indicate that after 1969 the stockholders of target firms have realized significantly greater gains and the stockholders of acquiring firms significantly smaller gains from acquisitions by tender offer.

What could account for this dramatic wealth-transfer from the stockholders of the acquiring to the stockholders of the target firm?

Let me list three prime suspects. The first is the Williams amendment, which was passed in 1968. Second is the proliferation of State antitakeover statutes beginning with Virginia in 1969. Finally, the insistence of the courts to adjudicate corporate control disputes according to the duty of care standards under the business judgment rule and not the more appropriate and more stringent standards of duty of loyalty.

All of these developments have worked to significantly increase the bargaining power of target managers which in turn has increased the gains to the stockholders of firms ultimately acquired by tender offer. But giving more power to target managers has also decreased the returns to acquiring firms, decreased the number of successful offers and undoubtedly decreased the number of offers initiated by potential acquiring firms.

My fear is that any more pro-target-management regulation will eliminate what incentive remains to engage in acquisitions like the tender offer and that ultimately this welfare-increasing transaction will be regulated out of existence. Thank you.

[The complete prepared statement follows:]

The Scientific Evidence of the Economic Effects of Corporate Acquisitions by Tender Offer

Exhibits to accompany testimony before the United States Senate Committee on Banking, Housing and Urban Affairs, April 3, 1985

Michael Bradley
University of Michigan

"Numbers serve to discipline rhetoric. Without them it is too easy to follow flights of fancy, to ignore the world as it is, and to remold it nearer to the heart's desire."

Ralph Waldo Emerson

OPENING STATEMENT

THIS MORNING I WOULD LIKE TO REVIEW THE SCIENTIFIC EVIDENCE CONCERNING THE ECONOMIC EFFECTS OF CORPORATE ACQUISITIONS BY TENDER OFFER.

MY PURPOSE IS TO INJECT THE AVAILABLE SCIENTIFIC EVIDENCE INTO THE DEBATE OVER THE PROPER ROLE OF GOVERNMENT REGULATION OF THIS CAPITAL MARKET TRANSACTION.

INDEED, MY HOPE IS THAT THIS EVIDENCE WILL BECOME THE FOCAL POINT OF YOUR DELIBERATIONS AS YOU CONSIDER PROPOSALS TO REFORM THE REGULATIONS THAT GOVERN UNNEGOTIATED TENDER OFFERS.

IT SEEMS RATHER OBVIOUS THAT AN ACCURATE ASSESSMENT OF CURRENT OR PROPOSED REGULATIONS MUST BE PREDICATED ON A SOUND UNDERSTANDING OF THE FACTS.

AN UNDERSTANDING OF THE ECONOMIC CONSEQUENCES OF ACQUISITIONS BY TENDER OFFER, UNDER THE CURRENT REGULATORY REGIME, SEEMS AN ESSENTIAL FIRST STEP IN FORMULATING NEW REGULATIONS.

RELATEDLY, I THINK THAT IT IS INCUMBENT ON THOSE WHO ADVOCATE A CHANGE IN THE STATUS QUO TO SHOW THAT THERE IS SOMETHING WRONG WITH THE CURRENT SYSTEM: SPECIFICALLY, THEY SHOULD BE FORCED TO DEMONSTRATE THAT UNDER CURRENT REGULATIONS, UNNEGOTIATED TENDER OFFERS REDUCE SOCIAL WELFARE.

THOSE WHO PROPOSE REFORMS WITHOUT SUFFICIENT EVIDENCE WOULD DO WELL TO HEED THE ADMONITION: "IF IT AIN'T BROKE, DON'T FIX IT."

DON'T CREATE ELABORATE REGULATORY SOLUTIONS TO PROBLEMS THAT DON'T EXIST.

MORE TO THE POINT, THE AVAILABLE SCIENTIFIC EVIDENCE INDICATES THAT MANY OF THE ALLEGED PROBLEMS WITH THE CURRENT SYSTEM JUST DO NOT EXIST.

IN OTHER WORDS, MY MESSAGE TO YOU THIS MORNING IS THAT THE TENDER OFFER MECHANISM "AIN'T BROKE, AND THEREFORE, IT DOESN'T NEED FIXING" - - - PARTICULARLY THE KIND OF FIXING THAT WOULD STRENGTHEN THE POSITION OF THE MANAGERS OF TARGET FIRMS.

WHILE CONTRARY ANECDOTAL EVIDENCE ABOUNDS, THE VIRTUALLY UNANIMOUS CONCLUSION AMONG FINANCIAL ECONOMISTS IS THAT CORPORATE ACQUISITIONS BY TENDER OFFER CHANNEL CORPORATE RESOURCES TO HIGHER VALUED USES.

ON NET, UNNEGOTIATED TENDER OFFERS CREATE VALUE AND HENCE ARE WELFARE-INCREASING TRANSACTIONS.

WHILE THERE IS SOME CONTROVERSY CONCERNING THE GAINS TO ACQUIRING FIRMS, THERE IS NONE REGARDING THE SIGNIFICANT CAPITAL GAINS REALIZED BY THE STOCKHOLDERS OF TARGET FIRMS OR THE FACT THAT CORPORATE COMBINATIONS BY TENDER OFFER ON NET CREATE ECONOMIC VALUE.

The Mechanics of a Two-Tier Tender Offer

A. Notation

F = Fraction of Target Shares Sought by the Bidding Firm

P_0 = Pre-announcement Market Price of a Target Share

P_T = Front-end of the Offer

= Price paid for the F target shares purchased in the first step of the acquisition.

P_E = Back-end of the Offer

= Price paid for the (1-F) target shares purchased (exchanged) in the second step of the acquisition.

B. The Market Pricing of a Share of a Target of a Successful Tender Offer

P_A = The Post-announcement but Pre-execution Market Price of a Target Share

With full subscription and pro rata execution

$$P_A = F \cdot P_T + (1 - F) \cdot P_E$$

U. S. Steel's Acquisition of Marathon

P_0 = \$50 - \$60

F = .51

P_T = \$125

P_E = \$90

$E(P_A)$ = 107.85

P_A = 107.25

C. Necessary Condition for a Successful Tender Offer

$$P_T > P_E$$

All successful tender offers are necessarily "front-end loaded"

Must pay a premium to induce target stockholders to tender

Typical Tender Offer: $P_T > P_A > P_E > P_0$

TABLE 1

Premium in Successful Two-Tier Tender Offers, 1981-1984

Year	Number	First Tier P_T/P_0	Second Tier P_E/P_0	Blended P_A/P_0
1981	12	68.9	41.5	54.9
1982	14	58.8	43.8	53.1
1983	6	82.4	76.1	79.5
1984	6	45.9	27.2	36.8
Total	38	63.7	45.6	55.3

Source: Economics of Partial and Two-Tier Tender Offers, Office of the Chief Economist, Securities and Exchange Commission, forthcoming update, 1985.

CHART 1

NET OF MARKET RETURNS TO THE SHARES OF 183 TARGETS
OF SUCCESSFUL TENDER OFFERS (135 INVOLVED IN SINGLE-BIDDER CONTESTS
AND 48 INVOLVED IN MULTIPLE-BIDDER CONTESTS), 1962-1980

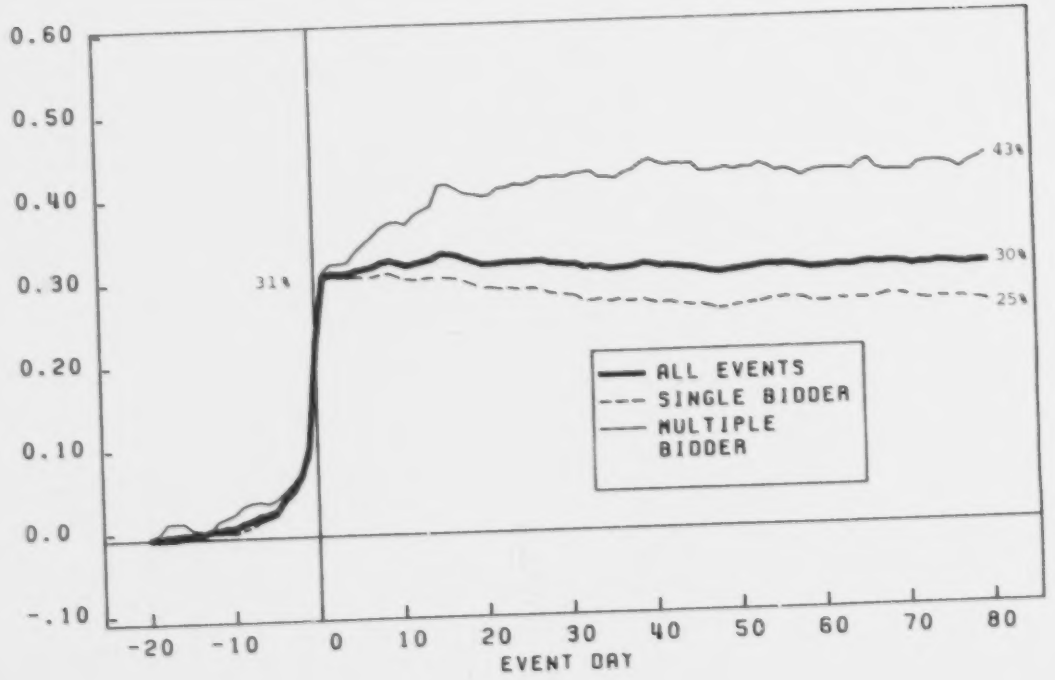


CHART 2

NET OF MARKET RETURNS TO THE SHARE OF 183 ACQUIRING FIRMS (135 INVOLVED IN SINGLE-BIDDER CONTESTS AND 48 INVOLVED IN MULTIPLE-BIDDER CONTESTS), 1962-1980

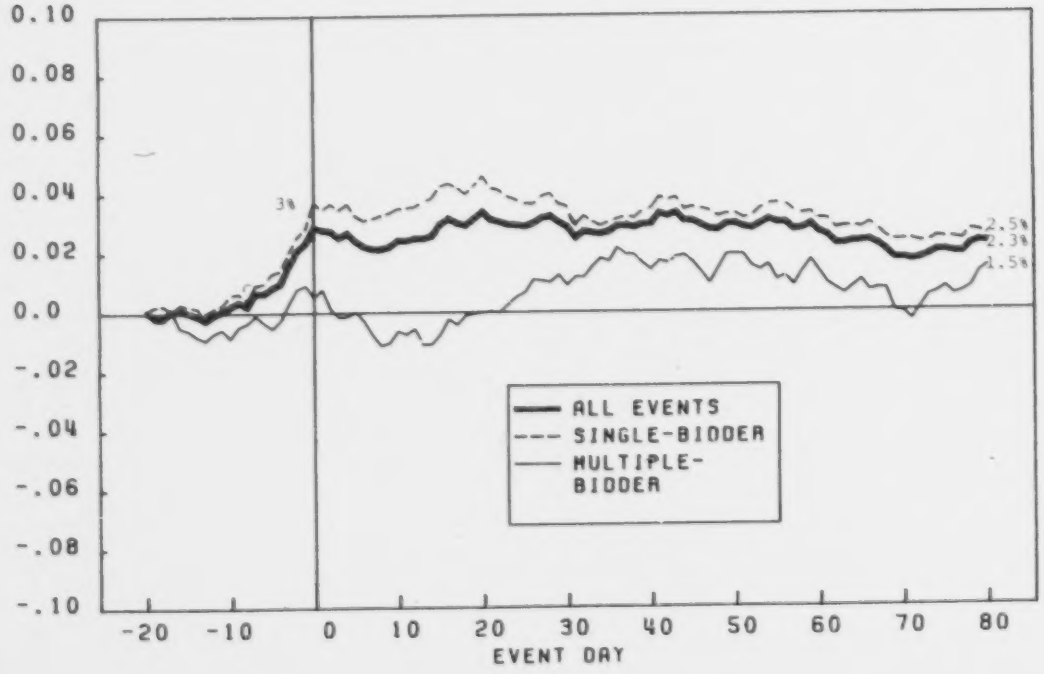


TABLE 2

DOLLAR GAINS TO THE STOCKHOLDERS OF THE 183 NYSE AND AMAX FIRMS INVOLVED IN SUCCESSFUL TENDER OFFERS OVER THE PERIOD 1962-1980

	MILLIONS OF DOLLARS		
	TARGETS	ACQUIRERS	COMBINED
TOTAL	4.795	1.061	5.875
MEAN	26.2	5.8	32.1

TABLE 3

AGGREGATE DOLLAR BLENDED PREMIUMS FOR NYSE AND ASE TARGET FIRMS, 1981-1984 (MILLIONS OF DOLLARS)

YEAR	NUMBER	MEAN	TOTAL
1981	33	$328	$10,809
1982	38	151	5,748
1983	24	96	2,308
1984	41	403	16,543
TOTAL	136	260	35,408

THE LARGEST PREMIUMS ARE:

GULF CORP. (1984	$6,035
GETTY OIL CO. (1984)	4,528
CONOCO, INC. (1981)	3,276
MARATHON OIL CO. (1981)	2,391
TEXASGULF, INC. (1981)	1,988
CITIES SERVICE CO. (1982)	1,422
ST. JOE MINERALS (1981)	1,015
BENDIX CORP. (1982)	786
ESMARK, INC. (1984)	891
MARTIN MARIETTA CORP. (1982)	876
CARNATION CO. (1984)	613
AVCO CORP. (1984)	575
SAINT REGIS CORP. (1984)	702

SOURCE: ECONOMICS OF PARTIAL AND TWO-TIER TENDER OFFERS, OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, FORTHCOMING UPDATE, 1985.

CHART 3

NET OF MARKET RETURNS TO TARGETS

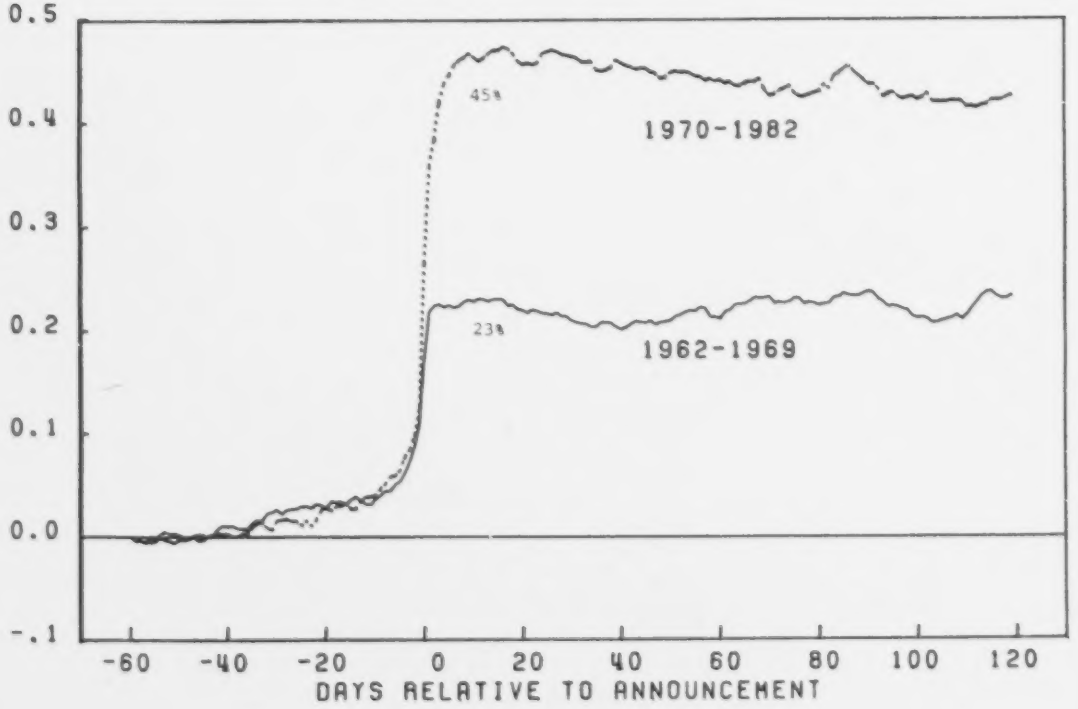


CHART 4

NET OF MARKET RETURNS TO ACQUIRERS

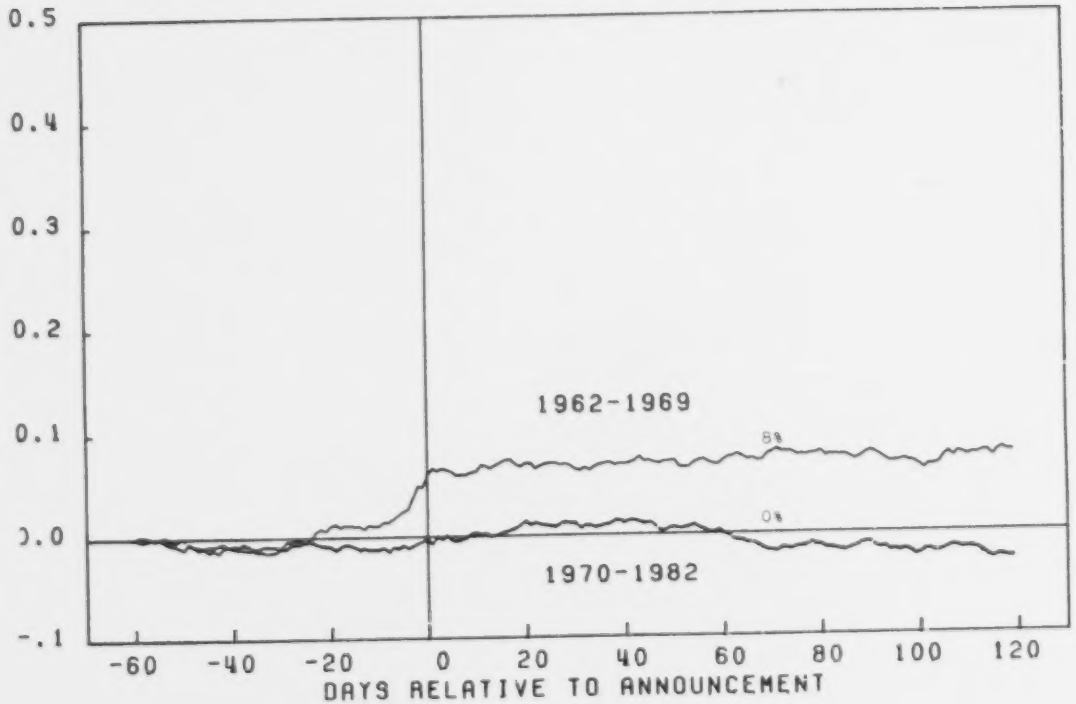
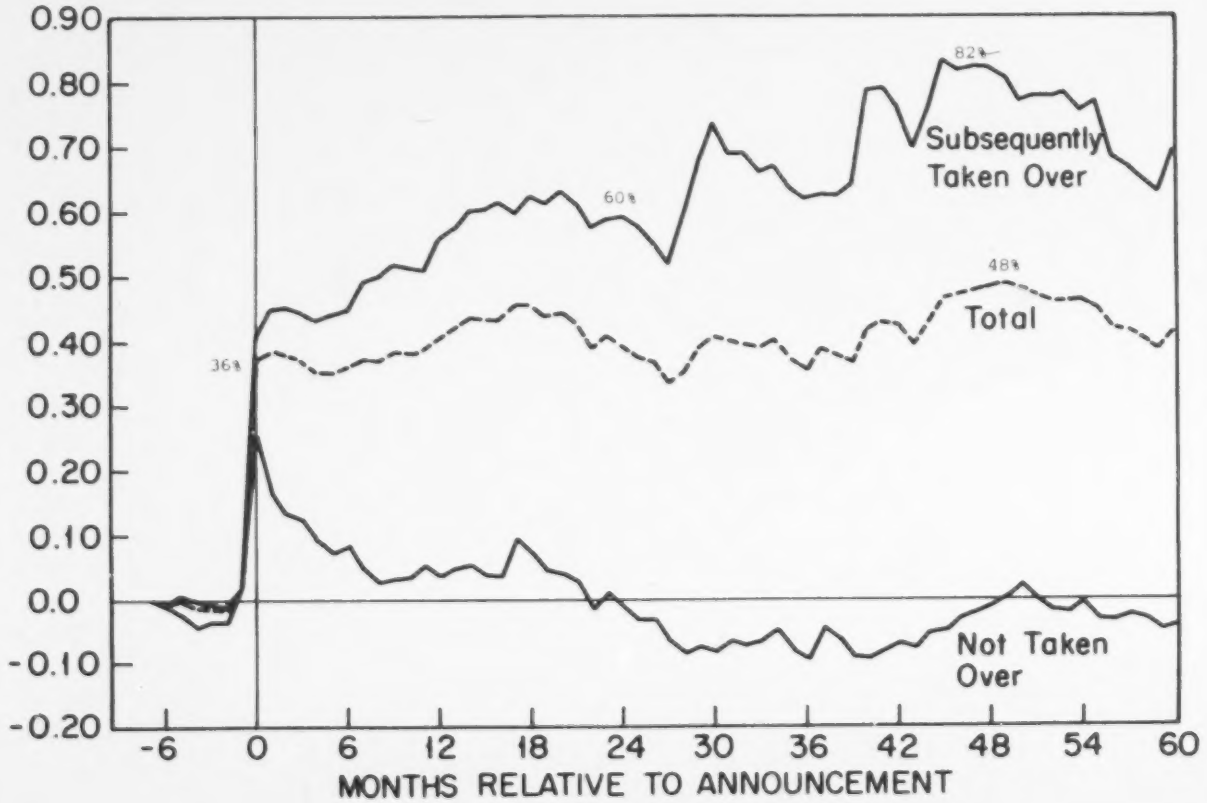


CHART 5

NET OF MARKET RETURNS TO THE SHARES OF 112 TARGETS OF UNSUCCESSFUL TENDER OFFERS
(86 SUBSEQUENTLY TAKEN OVER AND 46 NOT SUBSEQUENTLY TAKEN OVER), 1962-1980



Senator D'AMATO. Thank you, Mr. Bradley.
Mr. Lowenstein.

STATEMENT OF LOUIS LOWENSTEIN, PROFESSOR OF LAW, COLUMBIA LAW SCHOOL, NEW YORK, NY

Mr. LOWENSTEIN. Thank you, Mr. Chairman.
In the letter from a member of the staff discussing my appearance here, it said I should feel free to disagree with Professor Bradley and——
Senator D'AMATO. Not just Professor Bradley—anybody.
Mr. LOWENSTEIN. Right.
Senator D'AMATO. Believe me, I'm sure Mr. Lipton is getting ready to disagree, Mr. Brinegar I'm sure doesn't agree, and Mr. Montgomery may or may not.

FIVE MYTHS ON TENDER OFFERS

Mr. LOWENSTEIN. In my written statement I tried to deal with five myths about the value of takeover bids in 15 pages and I don't know if I can cover all five in 10 minutes but maybe I can cover at least two.
The myths are as follows: First, that there is systematic, scientific evidence that tender offers produce real gains in productivity.
The second is that the scholars are in general agreement about the first myth.
Third is that tender offers ought to be conducted much as we would conduct a fire sale—do it quickly, so as to favor the initial bidder.
Fourth, that tender offers are an essential element in disciplining corporate managers without which the managers, would run the business too much for their own personal ends.
Fifth, that in this process we can rely on corporate shareholders who are after all betting their own dollars and by protecting their own personal dollars they will indirectly protect all of us.
This not being a campus, the extent of scholarly agreement or disagreement may not be of much interest, but let me just state that the extent of the scholarly disagreement with the views expressed by Professor Bradley, by the Council of Economic Advisers, by Professor Jensen, of the SEC, OMB and the like, is extensive. Tobin, Shiller, Mueller, and others have all written extensively, rejecting one or more aspects of the orthodox argument.
There is for some reason a tendency on the part of Jensen and others to ignore that disagreement and insist on unanimity. I submit to you that ignoring the disagreement will not make it go away.
The scientific evidence is based on a single fact and one only. It's based on the fact that the target company shareholders reap substantial market gains as a result of a takeover bid. Now you and I might have thought that if the target company shareholders receive a premium, that would be the beginning of the inquiry and not the end. Obviously, you can't do a tender offer without offering a premium over market.
The more difficult question then becomes, first, whether those market gains are accurate indicaters of underlying gains in produc-

tivity and utilization of resources; and second, even staying on the level of stock market prices, what happens to the bidder?

Well, the data about bidders is quite inconclusive. It shows in some cases modest gains to the shareholders of the bidder company. In some cases it shows losses. Some of the gains to the bidding company shareholders were enjoyed long before the bid, making one wonder whether it was the move in stock price which induced the bid or whether it was, as the financial economists would suggest, that the takeover bid induced the gain.

Almost all of those numbers—and Professor Bradley's are symptomatic—all of those figures about gains to target company shareholders are over a very short time period, 60, 80, 180 days after the event.

In any event, the gain to the shareholders of the bidding company, whether nonexistent or slightly positive, frame the difficult question of what kind of process have we embarked upon when, focusing presumably on undermanaged companies, the bidding company keeps no significant gains for itself.

MARKETS HIGH TURNOVER

I submit to you that there's a more appropriate and realistic view of the tender offer process and that it would be substantially as follows: That the day-to-day trading market has become in recent years an increasingly high turnover, volatile market; that the turnover of shares on the New York Stock Exchange has increased 500 percent since 1960. The average annual turnover rate is now 60 percent and for institutional investors it is now 100 percent.

Compare, if you wish, that market to the one for companies as a whole. When one looks at oil companies as a whole, one finds prices that would be in the range of $6 to $8 a barrel. I don't know what the figures are for Union Oil Co., but I would guess that they are not very different from those of Exxon which I do know, and at the moment if you buy a share of Exxon you're buying oil at $3 a barrel. There are 17 barrels of oil per share of Exxon and Exxon sells for less than $50 a share. Is the market pricing shares in Exxon efficiently? Perhaps in the day-to-day trading market. Is that relevant to the whole company price of Exxon? I submit to you that it's not.

The same would be true of property and casualty insurance companies which almost invariably sell for ratios to book value of about 175 percent and yet one can buy property and casualty insurance companies in the day-to-day market at figures not much above and sometimes below book value rather than at the large premium.

We are witnessing today large numbers of acquisitions, some friendly and some hostile, of media companies. Why? Media companies, as a whole, are worth 11 times cash-flow, give or take. A cable TV company, $1,000 per hookup; it's almost a fixed number—$1,000 per hookup. Are the media companies selling for those prices on the day-to-day market? No, they are not.

In effect, what Mr. Pickens, Mr. Steinberg, and Mr. Icahn and the like are doing is simply arbitraging two markets. We have the

day-to-day trading market with its set of pricing criteria, too often focused on a high turnover performance game played by the institutional investors, and we have a quite different market for corporate control and whole companies.

If instead of looking at stock price movements we look at the underlying reality, we see things differently. Mike Scherer of Swarthmore testified recently before the Wirth committee that in a study of acquired companies he found—and I'm sure that most of us who have been corporate executives would confirm—that acquiring companies sought out well-managed companies, not the prototypical undermanaged company of Professor Bradley's testimony.

In my study of all the hostile company targets of 1981 I found an average return on equity of 16 percent—not bad. Professor Herman and I at Wharton School are trying to extend that study at the present time.

Let me deal with one other myth. That is the myth that if you offer a shareholder $40 or $25 for a share of stock that's all you need to know. The shareholder should be allowed to decide. The response to that, I suggest, is that while it was once thought that a tender offer was a sort of latter day town meeting of the market price, a democratic referendum of the quality of the management, that that view is now widely discredited.

The shareholders may have a common interest, but there's no mechanism for acting upon it. Their only bargaining agent is the management of the corporation. Their only means for collective response is the management or board of a corporation. And the result is that we often see not the two-sided balanced negotiations beloved by Congress, but rather a race to the door.

The result is a void. Management is effectively put in the penalty box or at least kept off the ice for the 5 minutes necessary for the bidder to make a score. That is a curious way to run the Nation's business.

With management confined to a secondary role, the protection of the shareholders and the future of the business depends almost entirely on outsiders, the third-party bidders, rather than on boards of directors and collective shareholder actions which are the theoretical instruments of corporate governance.

NEED TO PROTECT AMERICAN INDUSTRY

We should think twice about a system that encourages the sale of a business if and whenever the market price of the company is out of step with long-term values. To state it alternatively, we should protect shareholders when they act like owners of a business and when they look to the long-term profits of the business. But when they play a short-term trading game, we want to be sure that the casino effects of a hyperactive trading market do not contaminate the basic business of running American industry.

Attached to my written statement I have included several legislative proposals and, like everyone's legislative proposals, I think mine are balanced. They do include some antigreenmail proposals. They would eliminate some of the adjectives from Marty Lipton's description for the junk bond aspects, the front-end load, the greenmail, and they would do one other thing—reflecting Senator Metz-

enbaum's discussion earlier—they would substantially eliminate those scorched earth defenses that are inappropriate responses to takeover bids.

Mr. Chairman, I thank you.

[The complete prepared statement follows:]

STATEMENT BY LOUIS LOWENSTEIN
AT HEARINGS ON APRIL 3, 1985,
OF THE SUBCOMMITTEE ON SECURITIES,
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
WASHINGTON, D. C.

Mr. Chairman, members of the Committee, thank you for inviting me to appear before the Subcommittee. The issues you are considering are important. They are important to the functioning of our capital markets and also to our system of corporate governance.

Since 1980 I have been a professor of law at Columbia University, where I teach corporate finance. In 1978-79 I was president of Supermarkets General Corporation. For over 20 years before that I was engaged in private practice with a large New York firm, where my work consisted mainly of corporate practice, and mergers and acquisitions in particular. I have at various times served on a number of corporate boards of directors.

There is a widespread belief that hostile tender offers should be encouraged, and I want to use this opportunity to dispute that proposition. The argument for encouraging takeovers comes from two groups: (1) those who believe that takeovers are systematically beneficial to the economy and (2) those who, apart from any concern about the economy, simply believe that if a bidder is willing to pay $40 for a share of stock that has been selling at $25, the shareholders are entitled to go ahead. Obviously, at some points the two arguments tend to merge, but it is useful to deal with them separately.

The argument that takeovers are systematically beneficial to the economy rests, I suggest, on several myths that have been energetically perpetuated.

These myths are:

(1) There is systematic, scientific evidence that takeovers produce real gains in productivity and social welfare.

(2) This evidence is not only scientific but essentially unambiguous, and the nation's scholars are in substantial agreement on the matter.

(3) The best way to conduct a tender offer is to permit it to close quickly, as if it were a fire sale, thus favoring the initial bidder and restricting the opportunity for either a competitive auction or a measured response by the target.

(4) The tender offer process is an essential element of the necessary discipline for corporate managers. Without it they would have too much freedom to manage the business for their own personal ends.

(5) Since the shareholders are betting their own money, they can be relied on to protect not only their own interests but society's as well and to do so better than those who might regulate the process.

To begin with, the scholars are not in agreement. The 1985 Annual Report of the Council of Economic Advisers, and Professor Jensen, for example, writing in the Harvard Business Review, both state that the "scientific" studies and scholarly analyses support the argument that takeover bids are beneficial. Those who disagree are painted as part villain and part fool, principally corporate managers trying to save their skins. In fact, the disagreement with Jensen and the Council of Economic Advisers comes not just from the executives and other players on the field, but from the scholars in the stands, scholars such as Tobin, Hayes, Law, Herman, Mueller, Scherer and others who have made known their concerns. Ignoring the disagreement will not make it go away.

But the lack of unanimity among academics is not the important issue. What is important is the substance of the argument -- and the Council of Economic Advisers report and Jensen's article state it quite clearly -- that the premium price paid to a target company's shareholders signals that improvements, real improvements, are in prospect. With relatively minor and self-correcting exceptions, the premium price tells us that the assets of the target company will be better utilized thereafter, or so we are told. The opportunity arises either because the management of the target company has been ineffective or because there are better uses for those assets in some other venture or because the transaction will permit a greater reliance on debt financing. The Council of Economic Advisers seems to believe that additional debt, and the tax benefits flowing therefrom, is socially beneficial.

These are not only myths but dangerous ones. As two University of Chicago professors have said, companies should be bought and sold "like apples." If one could believe that premium prices consistently signal a useful redeployment of assets, then perhaps corporations should be dealt with as merchandise rather than as complex economic and social institutions. If not, however, it represents a view of corporate power divorced from responsibility. The apple sellers would have a machine tool company in Wisconsin march to the same beat as the block trading desk at Salomon.

What the Council of Economic Advisers and the OMB are saying is that stock prices are a highly efficient mirror of how well companies are performing, not just for whole groups of companies over long periods of time, but for individual companies at particular moments in time. The evidence for this view, called the efficient market hypothesis, is, in fact, ambiguous. Since Keynes it has been widely recognized that the stock market is not a model market, in part because it

is an almost wholly secondary market -- meaning that the shares are bought by traders or investors and sold only to other traders or investors -- and in part because the judgments in the stock market depend upon factors which are essentially unknowable. By unknowable I mean that the value of stocks depends on the one hand on very difficult projections as to future earnings and dividends, and on the other hand on the valuation of those future returns, the price earnings ratios, for which there are no objective criteria. The result is that investors tend to look more to each other, or as we say, play the stock market, than would occur in an ideal market.

This tendency of investors to play the market, rather than act as long-term owners of the underlying business, has been growing of late. We invest less, we trade more, and the pace at which we trade has become disturbing. The annual rate of turnover of shares on the New York Stock Exchange has increased five times since 1960. The annual turnover rate is now 60% annually, and for institutional investors as a group it is now 100%. As Tobin and Mueller have noted, the cost of all these transactions now exceeds the value of all new stocks floated annually. The cost of maintaining the market seems to exceed a primary purpose of the market. Active, liquid markets are useful, but was the stock market illiquid or inefficient in 1960?

Shiller has shown that, as one would expect in a hyperactive trading market, the fluctuations in stock prices greatly exceed the changes in expected returns on which stock prices ought to be based. If Shiller is correct, the linchpin of the argument by the Council of Economic Advisers, OMB, and the financial economists fails. And it is not just Shiller who has done useful work in this field. Other studies, for example, show that the returns from investing in stocks that are out of favor may be as much as 800% better than those which

are in favor and thus sell at high price earnings ratios. In a lecture last spring at Columbia, Warren Buffett of Berkshire Hathaway also produced data quite inconsistent with the model of perfect pricing on which the Council of Economic Advisers and Jensen depend.

The argument that takeovers are efficiency producing for the American economy generally rests on the single fact that the bidder pays -- as obviously he must -- a premium for the target company shares. But the premium price should be only the beginning, not the end of the inquiry. What about the bidders, for example? Their shareholders gain, too, but the gains, if any, are so small as to be statistically insignificant. Some studies show distinctly negative results for bidders, and sometimes the gains appear years before the bid. Mueller has argued that adjusting the large premium to target company shareholders for the small size of these companies relative to the bidders, the composite result may be little or no gain whatever.

What seems to be happening, therefore, is that bidders, although incurring most of the costs and risk of a takeover bid, are willing to giv virtually all of the market gain to the target company shareholders, hardly a deserving lot. From what wellsprings of generosity does such a marketplace emerge?

Even if the stock market were relatively efficient as a trading market, the argument for unrestrained takeovers would still be in error. It would be in error because it assumes that the price at which 10,000 shares sell in the day-to-day trading market is a good proxy for, or indication of, the value of the business when sold as a whole. The prices in these two markets, however, are in fact only loosely connected. For example, property and casualty insurance companies often sell at about book value, although it is common knowledge that if

you want to buy the company as a whole you would have to pay about 175% of book value. Similarly, cable TV companies sell as a whole for about $1,000 per subscriber and broadcast companies sell for about 11 times cash flow. As the recent wave of media company takeovers suggests, prices in the stock market frequently wander away, quite far away, from the underlying or whole company values. Exxon today sells at less than $3 per barrel of oil in the stock market, but obviously it would cost two to three times that much to buy the company as a whole.

What Icahn and Pickens are in large measure doing, therefore, is arbitraging two different markets. If that helps to discipline corporate managers, the discipline is hard to find.

Do bidders generally select poorly performing targets, or is the process more a random one? The available data is incomplete. The scientific evidence consists entirely of studies of the changes in stock prices of the target and acquiring companies for periods before and after the takeover. But stock prices are not by themselves a reality. A company is not more profitable because its stock rises. Stock prices are like a mirror and are useful only insofar as they reflect reality. One would think it useful, therefore, to determine whether targets have been undermanaged by looking at their financial results, not just at their stock prices, to see how well they have done.

When I looked at all the industrial company targets of hostile takeovers in 1981, I found that they had an average return on equity over a four-year period of about 16%. Not bad. Something else might be going on, and whatever that is, we need more data. Professor Herman of the Wharton School and I are now trying to do a more thorough financial analysis of hostile takeovers, and perhaps we will have additional insights into the romantic view that highly competent

bidders systematically seek out and prune target company deadwood.

I recently completed a study of 28 proposed management buyouts of large public companies, involving $100 million or more. The management had decided to go private and to buy out the public shareholders.[1] These buyouts are relevant to your concern about tender offers, because these two types of transactions have tended to merge. What happens is that a management offer to do a leveraged buyout often induces a third party to make a tender offer; and similarly a third party tender offer, or the fear of one, often produces a management buyout. The prices of the two types are essentially competitive with each other. That study disclosed that the median premium received by shareholders was 58% over the pre-announcement market price. Not surprisingly, the premium varied directly with the number of bidders, so that if there were three or more bidders the premium was 76% but if there were less than three bidders the premium was only 48%.

Gains of that magnitude might suggest to the Council of Economic Advisers large gains in asset utilization. I was unable to find them. In large part the premium prices reflected tax gains, much of which seem not to have been intended by Congress. The tax benefits were, depending on the company, (a) large interest deductions, (b) an aggressive write-up of asset values, (c) the amortization of those asset values on an accelerated schedule, and (d) in a few but growing number of cases, the adoption of an employee stock ownership plan or ESOP. Except for the ESOPs, the ingredients are familiar, but the distinctive end product is that a management can, with suitable backing, purchase its business

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1 Articles on this study will appear later this year in the Harvard Business Review and the Columbia Law Review.

from the public and finance the premium portion of the purchase price entirely out of tax generated cash flows.

Other, more real gains from these buyouts are harder to find. Out of pocket costs of $10 million or more are common. Productivity improvements might have been expected from the managers' much increased equity stake in the venture, but there are offsetting negative factors. The managers often take down large cash sums at the time of the buyout, thereby reducing perhaps their motivation as well as their risk. High debt-equity ratios may keep a usefully cash hungry wolf at the door, but they also limit flexibility.

After three to five years, after the acquisition debt has been paid down and the managers have fulfilled their contractual commitments, there are powerful pressures for all concerned, the managers, investment bankers, lenders and investors, to sell the new, private firm as a whole, or by a public offering to sell a part. In either case, the newly rejuvenated executive team of just a few years earlier will have lost its brief day in the warm sun of private, entrepreneurial ownership.

These 28 companies all went private, or were sold to third party bidders, at a median price earnings ratio of 17 at a time when the market index average was about 10. Almost by definition there are not likely to be productivity or other real gains to justify such a premium, particularly if the same management remains on. If the benefits of private ownership were as substantial as is sometimes alleged, why are these companies being resold so often and so promptly at about the time the tax benefits expire?

In three of the last six years the net equity of American industrial corporations has declined, thus reversing the historic pattern. We are leveraging American industry as we have not done since the 1920s. The net

decline in the equity of nonfinancial corporations was about $89 billion in the year 1984 alone, although 1984 was a profitable year and dividend payout ratios were relatively modest. There are a number of reasons for this increasing reliance on debt financing, but mergers and acquisitions are clearly a significant factor. Leveraged buyouts now account for a substantial percentage of all business acquisitions and even tender offers, and the defenses to tender offers, rely increasingly on debt. Witness the acquisitions of major oil companies, such as Cities Service and Marathon. Phillips Petroleum, in defending itself against hostile bids, turned itself from a company with a debt to total capital ratio of less than 30% to approximately 80%. Is that what the Council of Economic Advisers meant by its shorthand comment that financial structures should be "more in line with prevailing market conditions"?

The financial economists have overstated their case. Until the 1960s there were no takeover bids and U. S. industry was at least as productive and competitive as it is today. The managers compete primarily in the markets for their products and secondarily they compete for capital in our financial markets. The newly discovered market for corporate control -- takeover bids -- may have some utility, but it has been greatly exaggerated.

That brings me to the second point, the one made most frequently by arbitrageurs and investment bankers. This is the argument that if a bidder is willing to offer the shareholders a premium over market, why should not the shareholders be allowed to take it? A profit is a profit, and what's wrong with that? The shareholders' dollars are at risk and as the Council of Economic Advisers said, let them make the decision. Why should we interfere? They can reject the offer if they so choose.

Again there is oversimplification. Whatever the merits of granting to shareholders the right, in principle, to sell the business, it is not in fact the shareholders of the target who decide whether a bid will succeed. The notion that a tender offer is a latter day form of town meeting, a democratic referendum on management, is a view that was once popular but is now widely discredited. The shareholders of a target company do not, indeed they cannot, effectively take a responsible role. They do have a common interest, but they have no mechanism for acting on it. Their only bargaining agent is the very management which the tender offer is designed to circumvent. What we often see, therefore, is not the two-sided, balanced market beloved by economists, but a race to the door.

The result is a void. Management is effectively put in the penalty box, or at least kept off the ice, for the five minutes necessary for the bidder to make its "score." The power to direct a sale of the corporate enterprise has been taken from the board of directors and given not to the shareholders but to anyone -- Pickens, Steinberg, et al. -- who chooses to put the company into play. Once the object of a tender offer, 80% of the targets do not survive as independent entities.

That is a curious way to run the nation's business. With management confined to a secondary role, the protection of shareholders and the future of the business depends almost entirely on outsiders, the third party bidders, rather than on boards of directors and the collective shareholder action which are the usual instruments of corporate governance.

What I am suggesting is that we think twice about a system that encourages the sale of a business if and whenever the market price of a company is out of step with long-term values. Stated alternatively, we should protect shareholders when they act like owners of a business and when they look to the long-term

profits of the business. But when they play a short-term trading game, we want to be sure that the casino effects of a hyperactive trading market do not contaminate the basic business of running American industry.

Wall Street exists to serve Main Street and not the other way around. The effects of this takeover bid process have been to frighten and distract well-run companies fully as much as others. There is no evidence that bidders look only for undermanaged or underutilized assets. And the process is taking its toll. Phillips Petroleum turned itself inside out to escape Pickens and Icahn. The New York Stock Exchange is under increasing pressure to abandon its 60 year old requirement of one share-one vote. If the SEC permits the Exchange to go ahead, and it is difficult to see how it can permit the Exchange to operate at a competitive disadvantage, then a major element of corporate democracy will have been lost. The result, while unfortunate, will not surprise those of us who believe that allowing arbitrageurs to put a company into play is a distortion of the function of capital markets. But we seem to be increasingly confused.

* * * *

I have read Senator Proxmire's bill and briefly I have the following comments:

I am in basic agreement that the best approach is to amend the securities rather than the tax laws. Chasing tender offers by using the tax laws either results in overkill or is like trying to catch a trout with your hands -- you're bigger, but with a little effort he can slip away. That's what happened with Section 279 of the Code, which was adopted in the 1960s to deal with so-called acquisition debt.

The issue then is how to amend the securities laws. In 1983 I thought that it would be sufficient to impose a 6-month waiting period, so that the bidder would be subject to more rigorous competition and the target would have time not only for a less frantic response but also to get shareholder approval for certain defensive tactics, such as Pac-Man.

It is clear now that my 1983 proposal, while useful in part, would not be adequate. In the last two years, there have emerged more and more greenmail situations, bidders with astonishingly large bank financing. These bidders are indifferent as to who buys, so long as the company is firmly in play and someone, anyone, does buy, even if it's the company itself, as when Phillips did an internalized leveraged buyout. No useful solution, therefore, can focus solely on the single bidder whose goal is to be not just a bidder but a buyer. When Mobil and the Bronfmans bid in 1981, they really wanted to buy Marathon and Conoco. No more. It's now a more purely financial play.

A second problem is that the Street as a whole is increasingly interested in playing the tender offer game. It might be called Olympia Pursuits. There are so many substantial players, Boesky, Steinberg, Icahn, Bass Brothers, Pickens, Belzberg and others, that it is surprisingly easy to push a company into play. Where it stops nobody knows, but nobody really cares either. Someone will pick up their chips at a profit, including the commitment fees to the banks that go along for the ride.

These investors, though they are hardly investors in any meaningful sense, tend to focus on a single company at a time, helping to destabilize the control, rather than each finding his own. Icahn follows Pickens at Phillips. They deliberately buy over 5% so that the world will know where the game is being played and hopefully join in the process. The more the merrier, particularly if

the target is large. As a result, it is not unlikely that, without anything so formal as a technical "group," they will collectively own a substantial percentage of the shares.

Who's left? Left are the ordinary investors, who are in part you and I, but in larger part are institutional investors. Once upon a time, it was thought that institutional investors could play a useful role in monitoring management, because being long-term investors -- their holdings were thought to be too large to permit them to be in-and-outers -- they would have both the interest and the skills to do so. What happened instead is that the institutions became addicted to the performance game, which is a catchy label for short-term trading. Any solution, therefore, that depends on locating true "owners," those who would reject a 30% or greater premium today to remain as long-term owners, is likely to fail.

At the 1984 Wirth Committee hearings, the suggestion was made by Charles Munger, Vice Chairman of Berkshire Hathaway, Inc., that instead of looking to the target company shareholders for help, we take the profit out of this trading game regardless of who buys the bidder's shares. His proposal was to use Section 16(b) of the Exchange Act as a model and to provide that any holder of more than 5% of the voting shares who disposes of them in less than five years shall pay the entire profit to the issuer, unless, of course, the shares had been purchased with the issuer's consent. (The latter would recognize, for example, the working relationships such as IBM has with certain suppliers.) The 5% figure meets all the usual needs of institutional investors. At the time I thought that the proposal was a bit of overkill, but I should have known better than to take lightly a suggestion by Charlie. It solves a large part of the greenmail problem at its source, and it would not matter to whom the shares are sold. It is a

solution that does not depend on finding the small needle of "old fashioned" investors buried in the haystack of Wall Street.

But there are issues other than greenmail. Suppose the Pickens-Icahn bidders for Phillips are actually willing to buy the company? No one would suggest that tender offers as such be prohibited, but the use of front end loaded cash bids and junk bond second step freezeouts raise serious questions of fairness to investors on the one hand and the use of speculative securities on the other. To those who have read the history of the electric company holding companies of the 1920s it may all sound familiar.

The two tier bid problem can be neatly solved using as a model the British City Code solution and changing only the threshold numbers. Anyone who acquires over 10% of the voting shares of a public company would be required to bid promptly for the balance, and at a no less favorable price. While the bidder could offer securities, it would be required to offer a cash alternative at least equal to the highest price at which shares had been purchased during the preceding twelve months.

I have referred earlier today to the one share-one vote issue. If the major stock exchanges and the NASD cannot be persuaded to act responsibly, a version of Lipton's one share-one vote proposal should be adopted.

I have spoken and written elsewhere about the wisdom of the British rule that would prevent any target company faced with a hostile bid from buying or selling significant assets or a significant percentage of its own shares without stockholder approval. Coupled with a minimum tender offer period substantially longer than the present 20 business days, it would permit targets to react in a more measured and responsible fashion and at the same time subject Pac-Man and some of the other scorched earth defenses to the approval of shareholders. While shareholder votes are sometimes mere formalities, I think that in these circumstances and with the disclosures that would be required, the process would have real value.

Senator D'AMATO. Thank you very much.

Let me see if we can't focus in on some of Mr. Lipton's descriptions of a two-tier takeover. I won't use all of the other adjectives, Marty.

TWO-TIER TENDER OFFERS

Let me ask you this. How would you deal with what you perceive to be that evil—the front-end loaded two-tier tender offer, the greenmail problem as you perceive it—and also I'd like you to comment, if you would, on some of what has been characterized as management's defensive techniques that fly in the face of legitimate shareholder governance? Are we seeing a swing to defend against takeovers to the point where poison pill legislation and other kinds of things are becoming so commonplace that we are depriving shareholders of participation or representation that they are entitled to?

If you would address both of those.

Mr. LIPTON. Yes; the proposal that I submitted to you and this committee on November 20, and which is contained in the written testimony that I submitted, I think, provides the essential means to accomplish those objectives.

There is no question that with the escalation of takeover tactics and the strengthening of the hand of bidders to stampede shareholders into making poor decisions with respect to their investments, there has been an escalation of the attempt on the part of corporate management to try to recreate a level playing field. That has not been successful. Today, the bidders are able to stampede shareholders into selling their shares before the directors of corporations have an opportunity to try to maximize value for shareholders.

There is no question that the takeover entrepreneurs have great objection to the so-called shark repellents, poison pills, and so on. What they are objecting to is a redressing of the imbalance and the taking away of some of their ability to bully shareholders into acting in the interest of the takeover entrepreneur and not the interest of the shareholder and the Nation as a whole.

What I have suggested is that we deescalate the tactics substantially, that we eliminate the partial two-tier tender offer, that we eliminate greenmail, that we eliminate the ability to acquire control without offering a control premium to all shareholders, by essentially providing that a potential acquirer cannot go beyond 5 percent of the outstanding shares of a target company without making an offer to all of the shareholders at a single price.

Senator D'AMATO. That 5 percent is a number that's negotiable. If we were to make it 10 percent, what would you say?

Mr. LIPTON. Well, I would make it 10 percent in the case of a true passive institutional investor but not in the case of the takeover entrepreneur. The true passive institutional investor is someone who would be barred from takeover activity with respect to that company for a period of 5 years. That person could go to 10 percent. I see no need for a higher level of ownership in order to accommodate institutional investors. Most professional institutional investors hold their ownership at that level or below and I see no

need for accommodation of the takeover entrepreneurs who wish to have higher levels of investment.

I would provide exceptions to the 5 and 10 percent level for venture capital, family holdings, transactions approved by management—transactions that are essentially designed to further the capital interest of the company involved but deliberately designed to preclude takeover entrepreneurs from having an advantage.

Senator D'AMATO. If that legislative initiative were approved by the Congress and were enacted into law, what do you think would be necessary, if anything, looking at the argument that Professor Bradley and Mr. Montgomery have put forth in regard to some of the tactics that management is now engaged in and attempting?

Mr. LIPTON. I think those tactics become in large measure academic and meaningless. These are tactics that are designed to deal with the specific abusive takeover tactics, but I do provide——

BUSINESS JUDGMENT RULE

Senator D'AMATO. Should legislation then be directed to deal with, what many perceive, to be an imbalance in the application of the business judgment rule? I, for one, have got to say that I think it's long overdue. I recognize States rights, and I think they are very important. I would like to see some local courts begin to make some decisions that would bring about more accountability. If we are to deal with greenmail, or the two-tier takeovers that's perceived by many as being a problem that Congress should address, what about the other side? And that is the business judgment rule, the poison pill, et cetera.

Mr. LIPTON. I would suggest that it might be well to wait before making a significant intrusion into the business judgment rule to see if the situation would not revert to what it was before. Remember, all of the defensive tactics that have been criticized have been responsive to these takeover tactics. I do think we have a serious problem, one that is developing on a rather escalating basis now of essentially depriving shareholders of the right to vote in the choice of management. And what I have suggested in my proposal is that companies that do not adhere to the principle of one share one vote be barred from the national market, that their securities not trade on the national stock exchanges and not trade in NASDAQ, again, a way of avoiding interference with State governance of corporations, but I think essentially achieving the purpose that all national companies, all major public companies, follow the one share one vote principle and to give the Securities and Exchange Commission rulemaking authority in order to implement that.

I think that with that basic principle that there be one share one vote and a requirement that that be implemented by removing the various charter amendments that are designed to impinge on one share one vote, we would have restored true shareholder democracy.

I go even further than that and suggest that the legislation provide free and equal access to the proxy machinery for any holder of the greater of $500,000 in market value of a company's stock or 3 percent of the outstanding shares of common stock. So that if shareholders are dissatisfied with the way management is tending

to its duties, they have the same opportunity as management on a yearly basis to conduct an election and replace the board of directors.

I think that would create the balance between the right of corporations to protect the entity as a continuing concern and to be able to manage the entity for long-term growth and long-term profit, but at the same time, protect against entrenched management, poor management, and give the shareholders a really meaningful way of influencing the management, of changing the management if that becomes necessary.

Senator D'AMATO. Professor Lowenstein, Some have suggested that a great deal of the problem—and I believe you yourself concurred—would be eliminated if we were to legislatively eliminate greenmail and require additional shareholder approval of all mergers, somewhat like the English system.

Mr. LOWENSTEIN. By that, if the target company is under attack, that any major event proposed by the board at that point—significant purchase of assets, sale of assets, issuance of shares and the like—be subject to shareholder approval?

Senator D'AMATO. Correct.

Mr. LOWENSTEIN. That's the pattern of the British City Code and I think there's a good deal to recommend that, assuming that you keep the playing field level by first reducing the incidence of greenmail, two-tier offers, and the like.

But let me address the primary issue. A proposal that a target company once threatened with or actually faced with a hostile takeover bid could not issue large numbers of shares, buy doggie stores as Marshall Field did when confronted with a takeover bid, paper the walls with shares as Treadway did, and the like—the response to that is sometimes that it intrudes on States rights in the area. I think all of us as we think about legislation in this field are concerned that the Federal Government not intrude in corporate governance matters traditionally left to the States.

ONE SHARE ONE VOTE

The issue it seems to me is whether the States act or do not act, because in the event of default Congress acting at the Federal level would be forced to address it. The one-share-one-vote issue illustrates that. For 60 years the New York Stock Exchange has had a rule mandating one share one vote. It's hard to think of anything more fundamental to corporate democracy.

Under competitive pressures from the NASD, the American Stock Exchange, the big board is contemplating dropping that rule. I don't know of anyone who has thought that the States would then pick up the slack.

Senator D'AMATO. How do we deal with that?

Mr. LOWENSTEIN. I would like——

Senator D'AMATO. I would suggest to you that I find that incredibly offensive, the fact that one shareholder's value of shares is nothing. It is wiped out.

Senator METZENBAUM. It's just gone.

Mr. LOWENSTEIN. I find it offensive as a matter of corporate democracy. I lobbied against it in my city bar association committee

meeting and the only votes I got were those of a former associate in my law firm and inside counsel of Goldman, Sachs, who presumably agreed with the views recently expressed by John Whitehead of that firm. I think that's a mistake for corporate America because if corporate America is not responsible to shareholders, there are those who will think of other less attractive groups to whom they could be made responsible. And I, for one, and I'm sure you, are in favor of keeping the responsibility to the owners of the business.

I worry that we will shoot ourselves in the foot with proposals like this. If the stock exchange cannot be induced or jawboned to keep this, and that essentially means inducing the NASD and the American Stock Exchange to adopt similar provisions, then I see no alternative to Federal legislation that—and my written statement has a paragraph endorsing in substance Marty Lipton's proposal regarding this. There you will have it, you will have Federal intrusion on that most basic aspect of corporate democracy, who votes, how many shares, what the voting rights are, but it will be by default. It will be because Delaware, New Jersey, New York, and the rest of the States would have failed to take up the slack.

Senator D'AMATO. How long do we wait? How do you give a message?

Senator METZENBAUM. I would say to the chairman, as a guest here, that my guess is that if he were to put a bill in barring the New York Stock Exchange—which I would be happy to join him in—I would think that would be enough of a message to the New York Stock Exchange that it would not happen.

Senator D'AMATO. But it's not simply the New York Stock Exchange. It's the competitive interest and those who will leave the New York Stock Exchange and threaten to do just that and that's the problem.

Senator METZENBAUM. That isn't too much of a problem.

Mr. LOWENSTEIN. There is some suggestion, however, that the NASD might prefer to have you do it by legislation rather than antagonizing members, but I know that if we don't get a consensus among the three groups involved most of us think that the ball will be in your court rather than Delaware and New York.

Senator D'AMATO. I'm wondering if I might intrude for just one further question. I have gone over my time.

Professor Bradley, you raised a point when you showed that the companies that have been acquired over a period of time listed in one of your exhibits had increased some $30 billion. What about the future? Have you studied what the effect will be on capacity, in terms of the productivity of those organizations and those companies? Will they be generating the same kind of product, the same kind of return in the area of oil exploration? Will those companies now be impaired as a result of the increasing debt structure? Have we analyzed the long-term run with respect to the economic consequences of those acquisitions?

Mr. BRADLEY. We have in terms of the stock prices. We have looked at the stock prices out for 5 years and we see no significant trend away from that evidenced in the first 80 days. This again illustrates what we in the profession refer to as the efficient market

hypothesis, that the stock price is an unbiased estimate of future long-term value.

To the contrary, if there were tendencies for these data to deviate after the 80 days, either positive or negative, that would evidence what we call a trading strategy which is a poor and inefficient capital market.

So my answer to you is in two parts. One, we have the stock price data and they are not significantly different if you carry those data out for 5 years.

The thing we have not done is exactly what you're suggesting to do, namely, tear apart this combined corporate entity to find out just exactly what synergies are being brought to bear on the issue. We in academics are accused of what might be known as naming our ignorance. We get to a situation where we don't understand something and we hang a fancy label on it and proceed as though we now understand it. Synergy falls into that category.

We talk about synergies as though we really understand what the economic forces are behind them but in fact we don't know and in fact there may be as many different scenarios as there are acquisitions to explain why this particular acquisition has affected long-term value.

Could I interject one point? I find it interesting that, on one hand Mr. Lipton argues for more regulation because the raiders are making so much money and, at the same time, Professor Lowenstein argues that we need more regulation because bidders aren't making any money at all. I find it curious that both positions support a call for more regulation.

Senator D'AMATO. My time has expired. Senator Cranston.

Senator CRANSTON. Thank you very much. I have many questions I'd like to ask but I think it might be more constructive if I use my 10 minutes in the following way: I would like to ask you, Mr. Montgomery, to use 5 minutes to say whatever you would like to say in rebuttal to what you have heard this morning; and then I'd like to ask Marty Lipton to use 5 minutes to rebut whatever he would like to comment on.

Mr. MONTGOMERY. Thank you, Senator.

EFFECTIVE USE OF TAKEOVERS

I was pleased that Marty Lipton made the distinction between the takeover entrepreneurs, the raiders, and the corporate takeovers. It seemed to give more legitimacy to corporations like mine that have effectively used takeovers to build a very strong company and I will submit later for you the record of what we have built over the last 15 years, essentially half from the growth from within and half by being able to make 28 acquisitions over the last 5 years and some of them started off certainly hostile.

I would like to point out that it's very difficult to throw out a very healthy baby just because of some dirty water in the tub and it appears to me that arbitragers do serve a very useful function in pointing out where there is a difference in value between the securities market and transfer prices to third parties. I think to single them out for special restrictions will have some impacts that maybe people haven't thought through.

For example, the ability to identify the disparities, to call attention to the disparities, sometimes has the effect of closing the gap to the benefit of the shareholders and to managements that would prefer to continue to run the companies independently for a while. And I think that anything that restricts the traditional role of the arbitrager probably has long-run economic effects that would not be positive.

I think if you look at the macroeconomic effect, one thing alone would probably close the gap between market price and transfer price to third parties, and that would be what many of you Senators in your opening remarks mentioned; and that is, if you can get interest rates down—high interest rates are at the root of agricultural problems, the root of trade problems, the root of many, many problems—if we can get interest rates down, then you're going to find that the P_E ratios of common stocks are going to soar. They're going to go back to some of the levels they were in the 1950's and 1960's. If you could do one thing to just take the fun away from the corporate carrions and equalize things in favor of the corporate champions, then I feel that would be the one thing I would recommend you doing.

You can't start fiddling with some symptoms when the primary cause here I think is high-interest rates. Thank you.

Senator CRANSTON. Thank you very much. Marty.

Mr. LIPTON. Yes, Senator. Several points. First, one share one vote. I think it's most inappropriate to single out the New York Stock Exchange to try to impose on the New York Stock Exchange the responsibility that Congress should have for establishing uniform national treatment with respect to corporate governance and corporate democracy. It is a matter for Congress. If Congress feels this is a problem, Congress should enact legislation, whether it's the type of legislation that I have proposed or other legislation. But I don't think that the New York Stock Exchange should be singled out as the culprit in the matter. It is not the culprit. They have tried very hard to establish principles of corporate democracy. Again, it has been the escalating takeover tactics and the responses of management to those tactics that have created the present problem.

GREAT DANGER TO THE NATION

Second, I think it's very important to recognize that the abuses of the takeover process are only one of the concerns that Congress must take into account. The process itself does give rise to some of the more fundamental problems such as the creation of additional leverage by the use of debt securities and second step acquisitions and so on, but the fundamental problem goes beyond the process. It goes into the question of whether the kind of leverage that we're building into the economy today is in the long run a great danger to the Nation. It goes far beyond just takeovers.

I think takeovers are a minor aspect of it, but the entire financial system is being leveraged up on a day-to-day basis. Trading today is in options, it's in futures, it's in options on futures. We have junk bonds. We have zero coupon bonds. We have national deficits that aggregate more than $1 trillion. We have a banking

system that in large measure must fund itself every night, overnight and if it's not able to do that it cannot continue to function. That kind of leverage ultimately results in a serious problem. Takeovers are only one aspect of it.

Now that sort of leverage is the product of a number of different problems—national policy, tax policy, accounting conventions, and so on. But to my mind, we have entered a period not dissimilar from that of 1927, 1928, and 1929 and there are apostles of this new era as well—Professors Bradley and Jensen among them—who see absolutely no problem in the kind of leverage that's being introduced into the economy, who find academic justification in efficient market theories, stock prices, and so on.

But fundamentally, we are creating a system which historically has resulted in crashes, panics, and depressions. We can go back to the 17th century to the tulip bubble; to the 18th century, to the South Sea bubble; to the 19th century, with the money panics; and the 20th century, to 1929. I think that we are again approaching a situation which gives rise to that kind of problem. Takeovers are just a minor aspect of it.

As Felix Rohatyn has described the current financial system, it is a great big casino, and when the number doesn't come up you lose your money and the system is in danger.

I think it's important that takeovers be placed in the context of the overall problem. We seem to be losing sight of soundness, sound balance sheet, sound financial practice—for that matter, sound mergers and acquisitions. I am not an opponent of sound mergers and acquisitions, but I think the takeover process that has developed over the past 3 years is leading to unsound practices in the takeover area just as we are falling into unsound practices in most of the other areas of the financial structure of the economy.

Senator CRANSTON. Thank you very much. I have about 2 minutes of my time left.

Claude, do you have any comments to make on what's been said so far?

Mr. BRINEGAR. I'd like to endorse Marty's comments that there's much too much speculation afoot. I sort of describe what is going on in our industry as an effort to stampede shareholders and new shareholders by the entrepreneurs with what I call a phony idea and using junk money—junk money to sell a phony idea. It is a cycle not unlike the South Sea bubble; the idea that you can somehow restructure, a magic term, 10 or 11 oil companies to make everybody better off and forget about tomorrow is nonsense. My table showed, to take Exxon, this idea—and I guess it applies to everybody--would require Exxon to take $25 billion from someplace—I guess from the money markets—and give up $25 billion in equity, and you go right down the line.

That's what the idea amounts to. It's a stampede and the shareholders are not able to understand, in my opinion, what is going on and it goes on too fast. That's an issue I know you dealt with in a number of bills and I believe the Nation needs time to stop and understand it. It needs time to think about what the consequences are in the long run before very serious damage is done to an industry that I know for certain is a vital part of America.

I went through the energy crisis and I know what it means if major oil companies are disabled. I don't think we want that. Mesa will not be looking for another Prudhoe Bay oil field. Mesa will not be looking to deep offshore waters trying to discover new ways to make synthetic fuels. Mesa says this is a sunset business. It is not. It's a matter of working hard and being innovative. This takes a long-term view and it's hard to deal with short-term speculative issues when you're trying to deal with long-term views.

Senator CRANSTON. Thank you very much.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Montgomery, I want to thank you very much for giving us another reason for the Congress to get to work on the deficit. You said that these high-interest rates are largely responsible for the "takeoveritis" we're suffering. There are all kinds of other reasons to get the deficit under control, but it seems to me you add another very persuasive argument.

Mr. Lipton, you have been involved in as many takeover fights as anyone. Can you cite to us any examples that appear of a hostile takeover or raid that forced management into making decisions they might not otherwise have made which have caused damage to the enterprise in their charge?

Mr. LIPTON. I think it's inappropriate for me to speak with respect to specific situations that I've been involved in, but I can say——

Senator PROXMIRE. You're lucky you have a loophole.

Mr. LIPTON. The ethics of my profession limit what I can say.

Senator PROXMIRE. You could say company X.

Mr. LIPTON. There are numerous instances on the public record of companies that have repurchased shares from professional holders and not from the balance of the shareholders and instances of companies that have made acquisitions for the purpose of deterring a takeover attempt, companies that have placed large blocks of securities with so-called friends.

ACTIONS THAT CAUSE DAMAGE

Senator PROXMIRE. My question, Mr. Lipton, was actions that caused damage to the enterprise in their charge—in other words, persuaded them not to spend as much on R&D, and so forth.

Mr. LIPTON. Well, I think that the damage to the enterprise comes in large measure from the restructuring of the capitalization of the business in order to create more leverage.

As you restructure the capital of a company to increase the amount of debt during the short run, you increase the per share price.

Senator PROXMIRE. You've seen that happen in a number of instances?

Mr. LIPTON. We see it happening almost every day. There are a number of reasons why they resort to debt rather than equity to create capital. Accounting and tax policies are the principal reasons, but more and more the pattern of takeovers and the pattern of demand of institutional investment managers for quarter-to-quarter earnings performance, earnings improvement, result in

companies increasing the leverage of their balance sheet using debt instead of equity, and thereby forcing the reduction in capital expenditures, reduction in research and development, in order to have the funds available for the service of the debt. There's a limited amount of cash flow that comes from the productive use of any aggregation of assets.

If all of the financing of those assets is equity, then you have most of the cash-flow available for the long-term improvement of the assets and improvement of the business. If most of it is debt, then a major part of the cash-flow must be diverted from capital improvements and capital reinvestment and into the servicing of the debt.

Senator PROXMIRE. They do it far more commonly in financing the debt?

Mr. LIPTON. Today, most financing is debt.

Senator PROXMIRE. Mr. Montgomery, as you know, Peter Drucker is one of the most respected observers of business practices in this country. He said:

> A good many experienced business leaders I know now hold takeover fear to be the main cause of the decline of America's strength in the world economy and a far more potent cause than the high dollar.

Do you believe that there's truth in that assertion?

Mr. MONTGOMERY. Not really. I believe that a certain amount of fear is very healthy. I think we all have a need for a very high comfort level and if we can entrench ourselves a little bit more firmly in office we all feel that that security will make us perform better. But in fact I think the opposite is true.

I think that I personally work and people that I know work better under the tension and pressures of knowing that if we don't do a good job, if we don't really perform—and that means maximizing value over a reasonable period of time for shareholders—we are going to get thrown out of office. I think that is part of the dynamic tension that's important. I think it makes better politicians and statesmen. I think it makes better business managers to have that kind of pressure.

Senator PROXMIRE. Is that your view, Mr. Brinegar?

Mr. BRINEGAR. No, it's not. I think we tend to be a little loose with words and I think Mr. Montgomery, when he says maximizing value can mean one thing, and when Mr. Pickens says maximizing value can mean another thing, and we are essentially caught in our industry—and I have to speak for that because that's where I am—in this arbitrage between what I consider to be a phony idea of value of what's being sold and stock market idea of value.

I mentioned in my statement some of the reasons for this gap, but I think to look at our entire industry and to say that we are all bad managers, which you have to do when you look at the statement, is nonsense. The entire industry cannot be bad.

What is wrong is some of the data and some of the concepts that are being sold are wrong. I think that by most measures our company is respected and viewed as a well-run company. We have a record of growth. Our shareholders have been with us for 25 years. Just as an example, someone who put $10,000 in 25 years ago now have $135,000 and 15 percent compound growth on investment—a

very fine record. We do not believe we are badly managed. We believe there's a bad idea that is afoot in our case, mainly that appraised value is a value that somehow you should produce. If I could produce a table that says appraised value and label it as such and get it published and copyrighted and create the idea that it's true, then we would be judged by that value. I think that's the wrong idea.

I think the stock market is relatively efficient, but I think at times it can get a speculative mania going based on a bad idea and these speculative manias have gone on in the past and I think quite possibly one is going on right now in our industry. So we have to be very careful.

DEEPER AND DEEPER IN DEBT

Senator PROXMIRE. Dr. Bradley, I'm very concerned with the tendency for this country in all kinds of ways and aspects to get deeper and deeper in debt. We have the Federal deficit. We have the trade deficit. Now we have corporate debt increasing partly as a result of this takeover situation.

Nobody has repealed the business cycle. What happens come the next recession when some of the more highly leveraged companies that have emerged from takeover deals go under?

Mr. BRADLEY. Well, one thing I should point out— there are two things I'd like to respond to. One is that the nature of the Federal Tax Code induces corporate managers to use substitute leverage for equity. The tax deductibility of interest payments leads corporate managers to push the leverage higher and higher and if there are some problems that perhaps could be rectified perhaps you would want to look at the tax deductibility of interest payments.

The other point to reckon with, while corporate bankruptcy is many times a traumatic event on a corporation, bear in mind in the advent and in the wake of bankruptcy these shares and these assets are not burnt or lost forever. Bankruptcy simply is a process in which the bondholders claims are adjudicated in terms of their priorities and we can't think of the notion of corporate bankruptcy or defaults on bonds, while I said it would be traumatic and costly for a corporation, that doesn't mean the end of that corporation or the resources over which it commands. Those resources will be redeployed and still exist in the economy.

So I agree with you that perhaps the concern in terms of eventual bankruptcies is that we may want to reduce or keep constant the level debt, but again we can't overplay this notion of bankruptcy with the idea that the firm will go away and all its assets will be dissolved.

Senator PROXMIRE. Well, I'm not just considering bankruptcy. The fact that as I say our National Government is deeper in debt than ever. We have a trade deficit that's enormous. We are very dependent on foreign borrowing. And now our corporations seem to be getting more and more highly leveraged, which is another way of saying more and more deeply in debt.

Mr. BRADLEY. Well, I think we have to make a distinction between borrowing or debt at the corporate level versus the Government or a personal level. When you think of debt or equity in a

corporate capital structure, the only distinction between the two is which group has the safer part of the earnings produced by the firm. In other words, bondholders just stand in line before equity holders. And what we're doing is in a sense piecing out the risks of the corporation between bondholders and equity holders.

It's not like my personal wealth where I have my personal equity and then I borrow somebody else's money. A corporation exists for the production of goods and services and it gets funds from both bondholders and stockholders. Stockholders and bondholders both lend money to the corporation. What they lend money for is simply a promise for a future payment. Bondholders have a promise of safer dollars and equity holders riskier dollars, but nevertheless, the corporation, if we can use that legal entity, is borrowing both from equity holders and bondholders. So from that perspective, I don't think it has the same concern for the corporation as it would for you or me.

Senator PROXMIRE. My time is up, Mr. Chairman. I wish I could lock horns a little further with Professor Bradley. Unfortunately, I can't and I have some questions for the record for Mr. Lowenstein if he could respond for the record.

Senator D'AMATO. Those questions will be submitted for the record and Professor Lowenstein will have an opportunity to provide this committee with a detailed answer.

[Response of Professor Lowenstein follows:]

Mr. LOWENSTEIN. There's little doubt that our tax system encourages such transactions, but what to do about that is a very complex inquiry. For example, in the study of leveraged buyouts referred to in my written statement to the committee, I mentioned several different tax incentives: The interest deduction, the writeup of assets, the ability then to take accelerated depreciation and ESOP's, or employee stock ownership plans. Some such deductions, at least when considered individually, may be useful. For example, in an inflationary period it is probably useful to permit industry to take depreciation deductions based on current rather than historic value. Similarly, it is probably not wise (and the history of sections 279 and 385 of the Internal Revenue Code tells us that it is probably futile) to try to prohibit interest deductions for merger-related indebtedness. The problem is that the tax distinction between interest on debt and dividends on stock may be counterproductive. But that is a problem of which mergers and acquisitions are but a small part. Perhaps Congress' increasing willingness to look at some of the fundamentals of our corporate tax structure will give us a fresh opportunity to deal with these concerns.

Senator D'AMATO. Senator Riegle.

Senator RIEGLE. Mr. Chairman, has there been a previous questioning round? I've been in the Commerce Committee.

Senator D'AMATO. This is the first questioning round and we have been attempting to limit it to 10 minutes. Then what I suggest is we will attempt to go back after Senator Metzenbaum if we have an opportunity and limit it to 5 minutes.

Senator RIEGLE. Very good.

Senator D'AMATO. I want to thank our panelists for being so patient.

Senator RIEGLE. Mr. Chairman, I have a great interest in this subject, as you well know, and as I say I happen to be the ranking member of the Science and Space Subcommittee of the Commerce Committee and we had a meeting this morning on the space station which is an $8 billion item and I was required to be there or I would have been here at the outset. I've had a chance to review most of the statements here and I'm going to pose some questions

and I'd like just brief responses to the extent that you can be brief and still meaningful with your responses.

One frequently cited justification for unfriendly takeovers is that these practices serve to discipline entrenched managers who have been lax in their responsibilities and that it is generally poorly run companies that find themselves targets. This is a major argument that's put forward and I would like just a very brief response from each of you as to whether the theory that contested takeovers primarily discipline incompetent managers is for the most part a valid one, especially in the timeframe now when there's a burst of this kind of activity.

TARGETS ARE USUALLY WELL MANAGED

Mr. LIPTON. Senator, in my experience, that's not true. In fact, the direct opposite is true in almost every contested takeover situation that I've been involved in. The management of the target company was good management and indeed if one reflects for a moment on the question it would be a foolhardy bidder who selected a badly managed target to make a hostile tender offer without the ability to examine it or investigate it, audit it and so on. Targets are well managed companies, not poorly managed companies.

Senator RIEGLE. Mr. Montgomery.

Mr. MONTGOMERY. I think an analogy to what the union movement has done for workers in America, even though union numbers are down as a percentage of work force, is a good analogy to use here. The threat of unionization I think, apart from good feelings that people have who treat workers fairly, have served to increase the benefits for all employees, even if not unionized.

I think similarly the threat of takeover, that there is a possibility that somebody may come in some day, whether you've done a good job or not, is the iceberg under a little tip of the public takeovers that we read about. But I think an enormous number of companies operate more efficiently because they never know when that phone is going to ring and I think that's one of the macroeconomic effects that you have to consider when we look at the tip of the iceberg.

I think that it's not—to answer the question specifically, I don't believe that too many of the takeovers are directed solely to mismanaged or undermanaged companies. I think the major difference is the fact that, because of high-interest rates, stock market prices are not reflective of the split-up values of the companies. But let's trust the shareholders. We haven't heard much about the shareholders this morning. The shareholder does benefit greatly by receiving the premiums and we haven't talked about the macroeconomic effects of what happens when that capital is put into use and I think that s another issue.

Senator RIEGLE. Mr. Brinegar.

Mr. BRINEGAR. Senator, until recently, we did not believe we could be a takeover target, and during this period when we believed we could not be a takeover target we were generally considered to be one of the best run companies in the industry.

The discipline of growth and the discipline of our outside directors was plenty of incentive for us to run ourselves well. We think we're being attacked by Mesa because we are well run and because

we have a balance sheet that does not have much debt and gives Mesa perhaps future leverage to continue their adventures.

We try to keep our debt low because we want to have the ability to borrow money to grow in the oil business. We think that's what we're supposed to be doing. But now we're beginning to wonder.

Senator RIEGLE. Mr. Bradley.

Mr. BRADLEY. No, I don't think that that's the primary purpose of tender offers to discipline corporate managers. I think there are many more important and direct checks and balances on corporate behavior within the corporation itself to curb managerial abuses, or malfeasance, or what have you and that we might look at the tender offer perhaps as a court of last resort. There's always that threat out there, as Mr. Montgomery mentioned, but I don't think that that's the primary purpose of the takeover.

Indeed, as Professor Lowenstein pointed out, there are many cases in which the bidding firm sought the target simply because of its management, because it was an excellently managed firm, and indeed that was the resource that was being sought after through the combination.

Senator RIEGLE. Mr. Lowenstein.

Mr. LOWENSTEIN. To paraphrase Mr. Montgomery, for whom does the phone toll? If the stock prices don't accurately reflect management skill consistently and if therefore good companies as well as poorly run companies are caught up in the net, then how does a well-managed company respond to the threat of a takeover bid?

I think we see—and I think Mr. Lipton was suggesting—is that increasingly they respond to the short-term pressures of the market with short-term measures.

I would just illustrate. In 1981, I looked quite closely at a company that happened to be based in Senator Proxmire's State, Giddings & Lewis, which was a target of a hostile bid. It would be hard to find a better managed company than Giddings & Lewis. It had a return on equity in the range of 26 percent and spent a lot of money on R&D but then a Canadian conglomerate, which knew nothing about machine tools, selected Giddings & Lewis because it was well managed. Had it been poorly managed, they would not have used it as a vehicle for entry into the industry.

Senator RIEGLE. It sounds to me as if there's some unanimity on this point; that poor management is not really a very strong argument in any broad sense.

But let me talk about the question of fairness to shareholders, because an underlying concept of our securities laws involves the concept of fairness to all shareholders and some kind of an absolute equity across the board.

EQUAL TREATMENT TO SHAREHOLDERS

I'm wondering to what extent are we finding that certain shareholders are being treated differently from others in some of these takeover deals and how serious a problem in this regard are we faced with if we value the principle that says shareholders ought to be treated equally?

Again, I'd appreciate pointed responses in the interest of time.

Mr. LIPTON. The basic takeover device today is the two-tier tender offer. It's designed to stampede shareholders into tendering. It deliberately creates a situation in which the quick afoot are advantaged at the expense of the slow. The slow are usually the unsophisticated shareholders. The quick are the institutions. And it is that basic unfairness that has given rise to most of the abusive takeover tactics.

Senator RIEGLE. Mr. Montgomery.

Mr. MONTGOMERY. I think that the States increasingly are adopting charter amendment provisions to direct against the two-tier takeover. The Commonwealth of Pennsylvania I believe for one has a provision where if 30 percent of a target's stock has been accumulated a tender must be made for the remaining shares.

I think that there are some things that can be done to equalize the playing field. I think that there should be another look at the securities laws in terms of let's take the so-called section 13(d)—the famous 13(d), which really doesn't do anything any more. I think you should eliminate 13(d) and have instead a simultaneous notice of any purchase or sale of 1 percent or more of the stock of publicly traded companies. I think that that would immediately notify at a very early stage who is interested and let other people judge the motives.

The problem with 13(d) now is that they call for present intentions for statements of purpose, and we all know that any time you want to confuse people you say, "It's my present intention," and it may sincerely be your present intention, but it certainly leaves open a change of purpose later.

So I think there should be a level playing field by simply opening up shareholder lists and have simultaneous notice when a major transaction takes place as to who is making the transaction.

Senator RIEGLE. Mr. Brinegar.

Mr. BRINEGAR. Senator, I believe that there are methods available for raiders who confuse and stampede shareholders that have not been changed, though I won't go into the details now, but I think when a raider comes at you it comes in a stampede, the ability to consider the long-term future of the company in light of this onrush of events is very difficult. Time moves rapidly. And I would refer, as I did in my report, to the article in the January Harper's that described in grizzly detail the proposals to destroy the Gulf Oil Co. and to I believe seriously disadvantage the long-term Gulf Oil shareholders, and I would like to submit part of that for the record because it does describe something that can be done legaliy today and is a great disadvantage to shareholders and a large group of the public.

Senator RIEGLE. Mr. Bradley.

Mr. BRADLEY. The first thing I'd like to point out is that by far the most frequent form of corporate acquisition by tender offer is the any-and-all tender offer. Over the last 4 years, 228 offers, 70 percent of them, were any and-all tender offers and only 17 percent were two-tier offers, whereas 13 percent were partial offers. So most of these, the vast majority of these takeovers are being effected on an any-and-all offer.

Senator RIEGLE. Let me ask you if you look at the size of the transactions, would that skew that data as opposed to the absolute

number of transactions? Would the smaller percentage represent larger entities so that the dollar volume of the total would be skewed the other way?

Mr. BRADLEY. That's correct. There is a tendency for two-tier offers to be used in larger firms just because of the capitalization and the risk of the investment that would be expected. One thing to keep in mind in the two-tier tender offer is that they are effected on a pro rata basis, which is to say that every tendering portfolio must receive and indeed does receive the same treatment in terms of the acceptance of the offer. So when we see the first and second tier, we are misled if we think that those who tender get the first tier and those who don't tender get the second tier. Rather, through this prorationing, the provisions set out in the Williams amendment, everybody that tenders gets their shares accepted on a prorationed basis. So I think that the current system does have built into it an equality of treatment among target stockholders.

Senator RIEGLE. Mr. Lowenstein.

Mr. LOWENSTEIN. Passing the two-tier bids for the moment, let me turn to greenmail, a more pressing shareholder problem.

Senator RIEGLE. It's a real concern of mine.

Mr. LOWENSTEIN. The bidder says, "Your company or your money," and the target company management turns to its shareholders and says, "It's your money or my job." And the greenmail gets paid. I don't know how to describe that except in terms of shareholder fairness.

Senator RIEGLE. Well, take it to the next point then. I'm wondering about whether, at the bottomline you're concerned that there is an unfairness to all shareholders that is approaching a dimension that has to be treated. That's what I'm asking.

DISGORGEMENT OF PROFIT

Mr. LOWENSTEIN. Well, I think there's a very serious problem of shareholder fairness there and that as a part of my legislative proposals I have a specifically antigreenmail provision which in substance says that anyone who purchases more than 5 percent of the outstanding security voting shares of a company, 5 percent would take care of institutional investors, and holds it for less than a significant period of time would have to disgorge the profit to the company.

Senator RIEGLE. Senator D'Amato and I have been working for some time on greenmail legislation and we hope to eventually be successful with it.

Senator D'AMATO. I might mention that legislation. As you suggested, I believe Stanley Sporkin made a presentation not too long ago in which he talked about disgorgement of those profits and returning them to the company. I might ask these gentlemen to comment with respect to that idea.

Senator Metzenbaum.

Senator METZENBAUM. Thank you, Mr. Chairman.

Vis-a-vis the last comment that my distinguished colleague and friend from Michigan and the chairman was saying about working on the greenmail matter, I just think there's such a great sense of

urgency on that matter, whether or not we fashion a total bill, it may be valuable to accommodate some of these problems on a piecemeal basis and bring them to the floor because every day we read more and more of some of the problems and some of the activities that are taking place.

Mr. Lipton, you propose a mandatory tender offer for all shares of anybody acquiring 5 percent or more of a company's stock.

Now I'm aware of the fact that IBM held 20 percent of Rolm for a period of time without indicating that its desire for an unfriendly takeover and finally did have a friendly takeover, as I understand it. Warren Buffet owns 13 percent of the Washington Post. GEICO has a 30-percent minority owner. I guess I could stay here for the next hour reporting on people who take more than the 5 percent interest and don't have any intention of a takeover.

Don't you believe that that is a problem? As you know, I myself have set a higher figure in the legislation I propose and I'm wondering whether you think 5 percent is enough.

Mr. LIPTON. I do think 5 percent would be an appropriate level, Senator, and you will see on pages 27, 28, and 29 of my submission of the draft bill exceptions to go over the 5 percent for specific situations that are beneficial and where more than 5 percent ownership levels would be appropriate.

POISON PILLS

Senator METZENBAUM. Mr. Montgomery, you talk about the problem of the congressional limit—that you don't look forward to a congressional action with respect to poison pills and that the courts are looking at it.

My question is, that while this takes place, you also, I think, reported how many companies—I think you listed them—have already adopted poison pill modifications of their own charters.

My question to you is: Would you or would you not support Federal legislation to outlaw poison pills, assuming we could agree it's egregious?

Mr. MONTGOMERY. No; I would not favor Federal legislation outlawing poison pills. I believe that either the States can address this issue or, more importantly, I believe that there is still one little glimmer of hope and that is that shareholders can take these issues directly to the shareholders of the company either through precatory resolutions or resolutions that would be binding on companies that outlaw poison pill shareholder rights.

Senator METZENBAUM. Do you know of any situations where shareholders have so acted?

Mr. MONTGOMERY. Well, just by coincidence, my company, Rorer Laboratories, is waging a proxy fight against the Rorer directors adopting poison pill shareholders rights and the shareholder meeting is on the 23d of this month. We feel that that's an appropriate forum, apart from action that we also have taken in the courts.

Senator METZENBAUM. Mr. Lipton, you talk about actions that Congress should take with respect to protecting the corporate management, but I don't think, as I read a summary of your proposal, that you've given any indication of what should be done with respect to management. Let's face it. This is not a one-sided issue.

The chairman has made that clear. There are great advantages to the stockholders in many instances in selling out and I don't think the Congress should be standing in the way. I'm going to get to Mr. Brinegar in a moment. But whether or not the company has a great record or not, there are some values to the company and if stockholders can all get $80 a share instead of $40 a share, I'm not certain that Congress should stand in the way. I do think there are strong reasons why Congress should prohibit some shareholders, usually the poorer ones, or less informed ones, or smaller ones, getting $50 and the others getting $80, as occurred in the United States Steel, Marathon, and some of the others. To me, that's so morally wrong that I have a little difficulty in understanding Mr. Bradley's point of view in not recognizing that there's an element of conscience and decency involved in that kind of thing.

Mr. LIPTON. Senator, I agree with you completely and the proposal I made merely removes the stampede aspects and the unfair aspects of the takeover process and very specifically provides for one share and one vote and total shareholder democracy so that if there is a transaction that the shareholders wish to pursue and the management stands in the way the shareholders have a quick and easy way of changing the management or forcing the management to accept that transaction.

All I propose is that we remove the unfair aspects and abusive aspects of the takeover process, but I have proposed also to keep the playing field level, that the shareholders have the absolute right, without fetter and without interference, to determine the future of the enterprise.

Senator METZENBAUM. Mr. Brinegar, you talked about your company being well run and I take no issue with that, but in the last analysis, I feel—and I was formerly a corporate officer—that the bottom line is the shareholders. It's they who have the right to be protected, not management, and not whether the company was or was not well run. If somebody comes along and says they are willing to pay $80 a share for Unocal and stock market price shows that it's $50 a share, I'm really not that concerned about preserving management's position, nor necessarily even preserving the company. I think that's part of the free enterprise system.

What I didn't hear as I listened attentively to your statement was any concern about how—Congress shouldn't be one-sided. We should try to find some element of balance.

What would you do to protect the shareholders who could get $80 a share for stock that's selling for $50 a share, assuming that all of them can get the $80?

Mr. BRINEGAR. Senator, I can answer that directly. I would probably tender my own stock for $80 a share.

Senator METZENBAUM. I think that's a good answer.

Mr. BRINEGAR. We do not oppose a cash tender for all shareholders. That has never been brought to us.

What has been brought to us—and I'm a director of the company and have a fiduciary role to see that the shareholders are properly represented, and I plan to fulfill that obligation—and if somebody brings a full cash tender, it would certainly be looked at closely and our investment bankers would help us.

OPPOSE STAMPEDE ACTION

What we do oppose is an effort to destabilize the company in any kind of stampede action. For example, this speaks to your 5-percent issue. Mesa with 13.6 percent of the company has proposed that we delay our annual meeting by withholding a quorum while they try to put a deal together. I think that's unfair. I think if they can put a deal together they should do it and bring it forward. They should not deny our shareholders the right to have a meeting. If they had 5 percent they could not, but with 14 percent perhaps they can.

Senator METZENBAUM. Have they made a proposal as to what their price would be to buy them out?

Mr. BRINEGAR. They have not.

Senator METZENBAUM. Have they indicated they would be receptive to such a discussion?

Mr. BRINEGAR. They have not. They have indicated they have some ideas, asking us to delay the annual meeting for 2 months, and asking us and suggesting that if we would not agree they would withhold a quorum if they could solicit it. I think that's unfair to the shareholders. We have had our meeting scheduled for months and we have had our proxy material out and we would like to vote on the director issue, which I think makes the company able to negotiate proper deals.

What I'm objecting to, Senator, is proposals that are not what you would see and I would see as a direct or full-fledged proposal that you can evaluate. But rather—and I don't want to take the time today, but there are proposals that have been made that are not fair to all shareholders because they are so complicated. They offer various kinds of junk money, various kinds of pieces of paper. If you move fast you might get a good piece. If you don't move fast you might get a bad price.

Senator METZENBAUM. Would you agree that we ought to extend the 10-day period to something like 60 days?

Mr. BRINEGAR. Very much.

Senator METZENBAUM. Would anybody take issue with extending the time period for consideration of an offer? Do any of you have any fault about that?

Mr. BRADLEY. There does appear to be a gain in speed in these acquisitions. I think that there should be a delay for the target stockholders to evaluate the parameters of the offer or for competing bids to be made, but perhaps 60 days is a bit long. I think that should be looked at.

Senator METZENBAUM. What would you think?

Mr. BRADLEY. I think maybe 20 days. Isn't it now 20 days as proposed by the SEC?

Mr. LIPTON. It's now 20 business days.

Mr. BRADLEY. Right. I think that is adequate.

Mr. BRINEGAR. Let me say that 20 business days goes by very quickly. Events come at you from all sides.

Senator METZENBAUM. If you can think that goes by fast you ought to see how fast my time has expired.

Mr. BRINEGAR. Senator, when you're deciding the future of a company that has a long-term past and a long-term future, I don't think 20 days is long enough.

Senator METZENBAUM. Mr. Chairman, I know my time has expired and Mr. Bradley is trying to have an opportunity to respond about whether this is a nonconscience position and I think I'd ask unanimous consent that he be permitted to answer or respond, not that I have more time.

Senator D'AMATO. Mr. Bradley.

Mr. BRADLEY. Thank you, Senator D'Amato.

I just wanted to clear up one thing that I wasn't able to do in my opening statement because I was rushed—I rushed myself, I guess. But in this United States Steel-Marathon acquisition, I think this prorationing has to be appreciated for what it is. For example, the front end of that offer was for $125. The back end of that offer was for $90. Now it's a complete misrepresentation of that offer to think that those who tendered got $125 and those in the back end got $90.

What in fact happened was that 95 percent of those shares were tendered. That offer was effected on a pro rata basis, which is to say if you tendered two shares, one of your shares would have been accepted for $125 and the other share would be accepted for $90 for this pro rata or blended price of $107.85. If you tendered 100 shares, 50 of them would have commanded that higher price and the other 50 the lower price. So it's not the case that those that tendered——

Senator METZENBAUM. That isn't always the case, is it?

OFFERS EFFECTED ON A PRO RATA BASIS

Mr. BRADLEY. Yes, it is. According to the Williams amendment in 1968, all oversubscribed offers must be effected on a pro rata basis. Now what has to be done—and this is days we're talking about—if those shares are tendered into pro ratables within that specified time period, then it must be effected on this basis.

My point is that in the Marathon case, 95 percent of those shares were tendered. They actually got into the prorationing pool. So there might be 5 percent of the stock out there unaccounted for, but the bulk of those stockholders got the classic pro rata execution on that particular offer and everybody walked away, large and small stockholder alike, with a per share premium of $107.

Senator METZENBAUM. My time has expired. I want to respond but I don't have the time.

Senator D'AMATO. Professor Lowenstein wanted to respond.

Mr. LOWENSTEIN. For a financial economist, the deal was fair. For the small shareholder, it might not have been. The institutional investors tendered all theirs, some of them trying to double tender. The people who were left out obviously were uniquely and uniformly and entirely small shareholders. So that 5 percent may have been as much as 15 or 20 percent of the mom and pop shareholders out in Nebraska—excuse me—Ohio.

I would add a footnote to what Marty Lipton said before about 5 percent rules and greenmail, and that is that there will always be an exception I think in any proposal for the IBM investment in Rolm and GEICO and the like, that is to say when the investment is made with the investee company's approval. No one intends to disrupt those kinds of arrangements.

Senator D'AMATO. Let me ask you, Marty—you say greenmail is unfair to shareholders of the target corporation. Let me ask you to explain why.

Mr. LIPTON. I don't say that greenmail is unfair to the shareholders of the target company. I see absolutely nothing wrong with a target company that feels that its future should not be determined by extraneous forces at the moment doing whatever is necessary in order to preserve the continuity of the entity.

I think what's wrong is a system that permits takeover entrepreneurs to seek to demand greenmail and I would eliminate it not by foreclosing the payment of greenmail but by foreclosing the ability of greenmailers to obtain greenmail positions.

I think the real vice is not the repurchase of shares in order to prevent the company from being forced into a liquidation mode at an inappropriate time. The real vice is a system that permits takeover entrepreneurs to gain footholds that enable them to profit at the expense of the rest of the shareholders.

Senator D'AMATO. Professor Lowenstein indicated in his legislative proposal that any profits received by those who have taken a short-term position of over 5 or 3 percent, would then be returned to the corporation.

Mr. LIPTON. I think it's an excellent proposal and I think it's deserving of consideration by the committee.

Senator D'AMATO. Would that eliminate your fear of the utilization of the methods?

Mr. LIPTON. Well, again, I think it would be a correction of an abuse. I would still urge on the committee and on Congress that there be a 5-percent limitation on ownership levels of nonpassive investors.

Mr. LOWENSTEIN. Senator, as you know, my proposal includes the best of both worlds, Lipton and Lowenstein, and that 5-percent provision that you talked about, coupled with Mr. Lipton's proposal that if you go over some threshold figure you must bid for all, but I would raise that threshold figure from 5 to 10 percent.

Senator D'AMATO. Mr. Montgomery.

Mr. MONTGOMERY. I take exception to the one-sided accusation as to who is responsible for greenmail. The only people that can authorize the payment of greenmail are corporate managers and I think that is clearly their responsibility and I think that it is a despicable practice and I think it can be corrected by the States adopting appropriate legislation which at least makes directors take payment of greenmail to their shareholders. But the abuse, again, is management's using greenmail as an excuse to entrench themselves further. There's no justification for it.

Senator D'AMATO. Mr. Montgomery, on that issue: What if the States do not move to deal with this greenmail situation? What would be the appropriate course for Congress to undertake then, if any?

Mr. MONTGOMERY. I think that, No. 1, one should give it some time because, again, one of the unloved methods of redress here is the proxy contest and I think we have to get back into elections if we believe in corporate democracy. I like some of Mr. Lipton's proposals to really bring forth a rebirth of corporate democracy.

I would think that if, within a reasonable period of time, the State and shareholders have not acted to outlaw de facto or de jure use of greenmail, then is the appropriate time for Federal legislation. I think it's a very serious and wrong practice. .

MATTER OF GREENMAIL

Senator D'AMATO. Do you have a specific legislative proposal that you would endorse dealing with greenmail?

Mr. MONTGOMERY. Not at the Federal level at this time. I think it would be more appropriate, as I say, at the State level.

Senator D'AMATO. Mr. Bradley.

Mr. BRADLEY. Yes. I underscore Mr. Montgomery's statement about who's the culprit in this greenmail. In fact, I'm reluctant to call the transaction greenmail. I call it a targeted repurchase where the target firm repurchases shares from a targeted individual and I agree with Mr. Montgomery in saying who's giving impetus to the greenmail situation.

Senator D'AMATO. That's not really this committee's concern. The concern is if it is identified as an abuse and those who profess both sides of the philosophical point here agree that there's an abuse—how long should we wait and what should our action be? Do you believe that this Congress, absent any legislation or any initiative on the State level, should undertake legislative action?

Mr. BRADLEY. Not at this time. I think the greenmail has been a recent phenomenon and I think we ought to let the capital market and the corporate democracy mechanism take care of that process or see what they do in that regard.

We do see some evidence that firms are adopting antigreenmail provisions in their corporate charters. Moreover, I think there is a tendency and hopefully a tendency of courts to judge these and other issues under corporate control under a duty of loyalty standard as opposed to what they are now doing under a duty of care business judgment standard. And I think the movements at the court level as well as stockholder democracy would go a long way to solve this problem.

Mr. BRINEGAR. Let me make just a comment on trying to define greenmail. You'd better be unusually perceptive and alert because the methods by which it can be put into play are often pretty subtle. I attended yesterday a hearing where both Mr. Douce and Mr. Pickens were there and everyone in the room seemed to agree that Mr. Pickens had received greenmail except Mr. Douce and Mr. Pickens. Mr. Pickens said that Mr. Douce insisted upon it and Mr. Douce said Mr. Pickens insisted upon it. And I think it is a form of greenmail and I don't think it can be easily caught up in a simply drafted piece of legislation. There are very subtle ways of doing it.

Senator D'AMATO. Senator Riegle.

Senator RIEGLE. Mr. Chairman, I have three questions which I think are important ones but I don't want to detain you so I'll try to go through them as fast as I can.

One aspect of this hostile takeover activity that has been brought to my attention is the almost instantaneous availability of very large blocks of credit that seem to be not nearly so readily available for other economic purposes, and I could cite examples. There

are a number which are familiar to all of us that have recently occurred.

But I would like to understand better, starting with you, Mr. Lipton, and you, Mr. Brinegar, to explain how the financing of some of these deals is done and whether or not you think there is anything wrong with a system where billions are raised virtually overnight for this kind of activity?

Mr. LIPTON. Yes I think there's something drastically wrong with a system which permits the kind of leveraged takeovers that are the current vogue and I think it presents a threat to the national economy.

Senator RIEGLE. Why? Explain why you feel that way.

Mr. LIPTON. Because I don't think that the normal investors or lenders prudent investigation and assurance of the soundness of the loan is undertaken with respect to those transactions.

Senator RIEGLE. Well, I'd like you to go a step further because that's a very serious charge to lodge. One assumes that the market system is quite sophisticated and very well developed in our country. Money moves around and people make decisions. This is somebody's money that's being used in these forms. I'd like you to take it a step further and either take a specific example or create a hypothetical example to show why you think that this is really somehow abusing the public interest or somehow threatening to the country in ways that we may not presently understand, but need to understand.

Mr. LIPTON. There's an inverse Gresham's law. The money is collected from very unsophisticated people who either deposit it in savings and loans associations or buy single premium annuities. That money flows up to those people who are able to promise the highest return. In other words, deposits of unsophisticated people are attracted by promising a higher return than is otherwise available in the financial system. Then there are those that provide the securities that provide the return, the bonds that provide interest rates of 16, 17, and 18 percent a year. Some of the institutions or organizations that are collecting the deposits promise 13 or 14 percent, or so on. This is just fine as long as you can keep doing it, as long as you can keep expanding, as long as you can keep liquidity in the market until there's a downturn in the economy. As we all know, that can't keep up forever and when it happens and there is a collapse and the people who get hurt are the most unsophisticated participants in the system. They are the ones least able to protect themselves.

FOUR MERGER WAVES

Senator RIEGLE. Well, along that line, it's my understanding that if you look back through history, there's been essentially four merger waves since the late 1890's. There was roughly a period from 1890–1904, 1919–29, and from 1960–69, and I'm wondering why is this current merger wave any different from the previous ones and why is there anything that attaches to this period of time that suggests——

Mr. LIPTON. Senator, we had a merger wave from 1974-80, but since 1980 we've not had a merger wave; we've had a liquidation wave.

Senator RIEGLE. OK. You term it as a liquidation wave. Who else would like to comment?

Mr. MONTGOMERY. Well, I think we all need to be a little humble about macroeconomic effects and I think that I will try to be humble and maybe Mr. Lipton and others will be.

I think if anybody wants to characterize the last 3 or 4 years as a period of no growth in goods and services and jobs, then I have difficulty holding a discussion on any other basis than the facts. I don't think there is any justification whatsoever for Mr. Lipton's position. I don't think the evidence is in and I don't think the full impact of the macroeconomic effects has been studied by any of us, with all due respect. I think to call junk bonds, which are simply higher priced bonds, the high price reflecting the increased risk, junk bonds is to—it's like hostile takeovers. A hostile takeover certainly isn't hostile to the shareholders who receive the premiums. So I think junk bonds is another one of those terms—probably the people who refer to junk bonds are on the side of defending managements, but there is nothing, again, no way you can stop legitimate leverage buyout that's on a friendly basis. If you take the number of excellent deals that have been done in this country on the divestiture of divisions of large corporations where a young entrepreneurial team or very often it's the management of the divested division have been able to become entrepreneurs by leverage that would make the takeover leverage look like a Sunday school picnic that is quite conventional.

These are the kind of macroeconomic effects we have to be thinking about when we concentrate on essentially trying to protect corporate managers who do not need Federal protection. I assure you we can take care of ourselves. Thank you.

Senator RIEGLE. I think both of you want to comment and I have one other point to raise.

Mr. BRINEGAR. I have to agree with much of what Mr. Lipton said. I do not believe that we should wait until the history of the collapse in order to understand the nature of this collapse. I think there is something apparently going on.

Senator RIEGLE. Would you pull the mike closer?

Mr. BRINEGAR. I said I hope we don't have to wait and write the history of this collapse to understand the collapse. We can learn something from the facts. I believe this is something that you can investigate by discussing it with the savings and loan administrators and others who are head and heels in this. I believe there is something of a pyramiding going in the junk bond business. I believe money is available much too easily and I believe that deals are being promoted on speculative notions that are not true. And all those things tend to lead to a wave that does lead to a collapse.

In the case, as I said earlier, in my own industry, I feel very strongly that the notion is being pursued that we can all be restructured and everybody can win and to hell with tomorrow. I think the idea is wrong and I think in time it will be realized to be wrong. It's being made possible by the easy availability of this new

source of money that has come out of deregulation of much of the monetary system.

Senator RIEGLE. Mr. Lowenstein, it seemed like you were nodding and I want to call on Mr. Bradley too.

Mr. LOWENSTEIN. I think that that question is very complex.

Senator RIEGLE. That's why we need to understand it.

SIGNS OF PYRAMIDING

Mr. LOWENSTEIN. On the one hand, you do see some emerging signs of pyramiding going on. I'm reminded of a large media company which recently sold over 1 billion dollars' worth of so-called junk bonds where the company's income statement shows that it is annually losing money at the rate of $100 million pretax and after tax. But, on the other hand, it kept enough money from the bonds to pay interest for several years and also agreed with some of the bondholders that they wouldn't receive interest for a number of years.

One has to be concerned about the marketplace's willingness to accept bond issues of this kind in any systematic way. If you're old enough to have lived in 1929 or read some of the history of the pyramiding that took place then, the fact that the market would take it does not mean that it's in our long-term interest to sell it.

On the other hand, the debt question gets very complicated because, I agree with Mr. Montgomery, that a number of buyouts are being done that have been quite salutary and yet done with borrowed money, where the entrepreneur buys his division from the perhaps swollen conglomerate.

And when you try to regulate in that fashion, through the Tax Code, I think you end up trying to chase something that's ephemeral. Either you overregulate, in which case you hear very promptly that you're doing too much, or you try to distinguish between people who borrow money to buy assets and people who borrow money to buy stock, and that is a distinction that collapses in practice. Or you end up writing a bill that's so targeted that it becomes meaningless, because the practitioners on Wall Street can work their way around it. That's what happened to the present section 279 of the Internal Revenue Code, an effort to legislate with respect to so-called acquisition debt in the 1960's. Most of us don't even remember what that section contains, because it's no longer relevant.

Senator RIEGLE. Mr. Bradley.

Mr. BRADLEY. Just one point because I think it relates to what Senator Metzenbaum and I were talking about in terms of this capital structure decision between debt and equity.

Again, I have to agree completely with what Mr. Montgomery said about this characterization of junk bonds. Junk bonds are nothing more than risky debt and if you can think of the ultimate junk bond it would be equity. So there's a continuum here and just because bonds are yielding higher rates of return reflecting the underlying bids, there's nothing inherently junky about those bonds. And again, this pejorative connotation that people like to hang on them that gets all these emotional discussions going, when, in fact, an economist just sees that as a very risky instrument that's going

to command a higher price—sure, there's a higher probability of default than it is on a U.S. Treasury bill, but that's reflected in the price.

The other thing I wanted to mention in these takeovers, that why the bidding firm will resort to leverage, as you well know and might expect, is that the need for cash comes up very quickly and the mobilizing cash particularly in a front-end cash offer, the cash has to be amassed very quickly and distributed to the target stockholders and debt through insurance companies and through the intermediaries having this access to the debt market is a very natural way of getting that.

Finally, when the target stockholders get that money they don't burn it. That money goes back into the system. It's a closed system and they might take it from overnight into their pocket or over 20 days but that money goes back into the system. So that money goes back in the system so I think it's erroneous to think that corporate acquisitions somehow are squeezing out other types of investment.

Senator RIEGLE. Isn't there perhaps a concern—and I'm posing the question because Mr. Lowenstein began to nod negatively as you were speaking on your first point here—that a bondholder doesn't necessarily think he's in an equity position, especially if he's at the end of a chain of transactions that he may feel that he's a bondholder but that he may be much more in an equity play situation than he realizes. Obviously, there's a big premium that's hung out there, but I'm a free market person and markets are imperfect, but I'm just wondering if there isn't some confusion that may exist out there where somebody could end up getting burned thinking they're in one category and finding out they're actually in another.

Mr. BRADLEY. That may well be. As we all know, information is a costly good, like any other economic good, and there may not be enough information being produced and, therefore, what might be the remedy would be to disclose information, disseminate information about what these bonds are. But I think that somebody looking at a bond with a 17, 18 percent expected return knows pretty much that that's not a Treasury bill and that there's some risk behind that instrument and it's beyond me to think that people are so naive to think that they can get 18 or 20 percent return on a very safe instrument.

I have faith in the efficiency of the capital market and the rationality of investors, but your point may well be taken that more disclosure might be needed if there is this pyramiding and people don't know where their funds are ultimately being invested.

Mr. LIPTON. I'd just like to point out that while most of the managers of savings and loans and insurance companies and other institutions that buy junk bonds probably do understand what the instrument is, the people who are entrusting their funds to those institutions do not; and it's their funds that are at risk in the junk bond market.

OVERHAUL THE TAX SYSTEM

Senator RIEGLE. I'm going to have you answer for the record because I know we are pressed for time, my question is: There's a

major proposal before us to overhaul the tax system, as you know. It's not in final form but it will be. I think it's very important that we establish whether the tax system today is neutral with respect to hostile takeovers, leveraged buyout, and acquisitions, or does the Tax Code as it now sits somehow impinge on this and either encourage it or discourage it? I want to know the impact of the current Tax Code at either driving this activity or retarding it, if anybody has a clear one-shot answer I'd like to hear it.

Senator D'AMATO. Senator, I don't want to cut off this line of questioning, but we're well over the allocated time.

Senator RIEGLE. Could we have answers in for the record for that because I think it's important that we establish this before we try to relate these things, especially because we're apparently on the verge of major tax changes.

Senator D'AMATO. I see Professor Lowenstein and Mr. Bradley have indicated their willingness to submit that for the record.

[Response to written questions of Senator Riegle follow:]

CooperVision

Parker G. Montgomery
Chairman of the Board

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May 2, 1985

Mr. Edward M. Malan
Publications Director
Senate Committee on Banking, Housing
and Urban Affairs
Room SD 534, Dirksen Senate Office Building
Washington, D.C. 20510

April 3, 1985 Hearing
on Corporate Takeovers

Dear Mr. Malan:

Thank you for your letter of April 17, 1985, transmitting the following question from Senator Riegle:

"Senator Riegle:

Is our tax system neutral with respect to hostile takeovers, leveraged buyouts and break-up liquidations or does it in fact encourage or discourage this activity?"

My answer to the question is as follows:

I do not think our tax system encourages or discourages this type of activity any more so than other types of business activity that benefit from the interest deduction and other provisions of the present tax code, nor do I think that acquisition indebtedness is a less valid business expense than other sorts of deductible expenses. Moreover, as I have stated, so-called hostile takeovers can in fact have beneficial effects for the shareholders of an acquired company as well as for the economy as a whole.

Sincerely,

P.S. I am returning herewith the Transcript of Proceedings marked to show changes on pages 80,83,89,90 and 105.

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* OF COUNSEL D.C. BARS ONLY

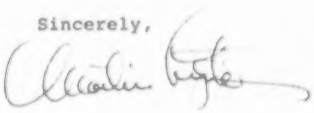
April 10, 1985

Honorable Donald W. Riegle, Jr.
SD-105 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Riegle:

The enclosed material reflects my answer for the record to your question, "Is our tax system neutral with respect to hostile takeovers, leveraged buyouts and break-up liquidations or does it in fact encourage or discourage this activity?"

Sincerely,



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United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510

April 17, 1985

Dear Mr. Lipton,

During the hearing of April 3, 1985, Senator Riegle did not have time to ask all of his questions in his allotted time. Therefore he requested that he could submit the balance of his questions in writing so the witnesses could respond for the record.

Listed below is the question Senator Riegle would like you to answer for the record:

Senator Riegle:
Is our tax system neutral with respect to hostile takeovers, leveraged buyouts and break-up liquidations or does it in fact encourage or discourage this activity?

Sincerely,
Ed Malan, Publications Director

IT IS NOT NEUTRAL. IT ENCOURAGES TAKEOVER ACTIVITY. THE USE OF JUNK BONDS IS A PARTICULAR PROBLEM. WHILE IN MOST CIRCUMSTANCES THE MARKET CAN BE RELIED UPON TO SELF-CORRECT, IT APPEARS THAT THIS IS NOT SO WITH RESPECT TO JUNK BONDS USED TO FINANCE HOSTILE TAKEOVERS. HR 1100 WOULD CORRECT THIS PROBLEM.

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*OF COUNSEL (NOT A D.C. BARS ONLY)

April 1, 1985

Ms. Rosina Barker
Staff of the Subcommittee
on Oversight of the House
Ways and Means Committee
1105 Longworth House Office
Building
Washington, D.C. 20515

Dear Ms. Barker:

You have asked for a brief summary of my views regarding Section 2 of H.R. 1100, dealing with the disallowance of interest deductions on certain types of acquisition indebtedness. H.R. 1100 was introduced by Congressman Jones and others on February 19, 1985. As you are aware, I am a member of the law firm of Wachtell, Lipton, Rosen & Katz, which has represented Phillips Petroleum Company ("Phillips"). As you are also aware, Phillips was the subject of a hostile takeover attempt initiated by Carl Icahn and other parties (the "Icahn Offer"), which was to be financed in part with "junk bonds" of the type that would be impacted by the enactment of Section 2 of H.R. 1100.

(1) The Icahn Offer was typical of an emerging form of hostile takeover financed in large part through issuance of subordinated indebtedness. The Icahn Offer involved an initial tender offer for approximately half of the Phillips stock involving consideration of approximately $4.3 billion. That consideration was to be furnished through the issuance of various securities of a newly established corporation. The objective of the tender offer was to acquire control of Phillips so as to cause the merger of the newly formed corporation into Phillips. In such merger, the remaining public shareholders of Phillips would receive junior subordinated debentures of the survivor aggregating approximately $3.9 billion.

The overall effect of this transaction, if consummated, would have been to leave Phillips with approximately $800 million in equity and over $11 billion in debt. Nearly $6 billion of that debt would have subordinated indebtedness issued either to the parties financing the initial tender offer or the public shareholders in the bank-end merger.

Thus, the effect of the Icahn acquisition would have been to raise the Phillips debt-equity ratio to over 13:1. This is far higher than the debt-equity ratio for any major oil company. Moreover, given the very small equity cushion supporting the various classes of indebtedness, it was quite apparent that the subordinated debt (particularly the $3.9 billion of junior subordinated debt to be issued to the public shareholders) would bear most of the downside risk of the Phillips business. From the point of view of senior lenders in the Phillips transaction, the subordinated debt served the same purpose as equity -- i.e., it provided a cushion to assure repayment of senior debt even in the event the Phillips business did not perform as expected. Nevertheless, as discussed below, the provisions in the Internal Revenue Code relating to the debt-equity distinction and to acquisition indebtedness (i.e., Sections 279 and 385 of the Code) as presently applied do not appear to raise a major risk of disallowance of interest deductions on such subordinated debt.

The effect of allowing interest deductions for all the acquisition indebtedness contemplated in the Icahn Offer would have been to generate as much as $600 million in annual tax savings. Such tax savings represent a tax subsidy for "junk bond" hostile offers of the type reflected in the Icahn Offer.

(2) Sections 279 and 385 of the Code were added in 1969 in large part to reduce tax incentives for then-prevalent conglomerate merger activities. Section 385 of the Code authorizes the Secretary of the Treasury to promulgate regulations dealing with the debt-equity distinction. Section 279 provides for the disallowance of interest expense on narrowly defined types of corporate acquisition indebtedness.

After a delay of over ten years, regulations were first proposed under Section 385 in March of 1980. The Proposed Regulations were thereafter substantially modified

and were published in final form in December of 1980. However, the final Regulations were subsequently withdrawn. The various forms of the Section 385 Regulations involve an enormous degree of complexity, in large part because they dealt with the debt-equity distinction in many factual contexts. After the withdrawal of the final Section 385 Regulations, the debt-equity distinction has generally been left to prior case law, supplemented by one published ruling. Under the case law, there is little authority for treating as equity debt not held by shareholders which does not include "equity" features such as convertibility.

Section 279 deals with the disallowance of interest deductions on a narrowly defined class of acquisition indebtedness. Since a debt instrument must satisfy a number of statutory tests (many of which are easy to avoid) before the interest deduction is disallowed, Section 279 is rarely a problem in practice.

Accordingly, current tax law rules do not appear to create any substantial degree of risk regarding the issuance of subordinated debt in hostile acquisitions of the type contemplated in the Icahn Offer.

(3) The effect of giving free rein to the issuance of subordinated "junk bonds" in hostile acquisitions is to provide virtually unlimited license for transactions which have the effect of virtually wiping out the corporate income tax liability of the companies which are the subject of such acquisitions. This unlimited license for ad hoc integration of corporate and shareholder taxes conflicts with the existing "classic" model of corporate taxation in the United States, pursuant to which corporate earnings are taxed in the hands of the corporation and again upon distribution to shareholders. It should be noted that such ad hoc corporate integration goes far beyond any of the contemplated corporate tax integration proposals contemplated by the current and prior administrations. For example, the integration proposal included in the Treasury Department's recent reform proposals would permit a deduction for dividends paid only with respect to half of the dividends and only to the extent such dividends were paid from the earnings actually subject to corporate tax. Neither limitation applies to ad hoc integration through highly leveraged acquisition transactions. The revenue loss inherent in such transactions is magnified because the subordinated debt in

question would tend to gravitate towards tax-free investors such as pension plans and companies with net operating losses.

(4) Section 2 of H.R. 1100 is an attempt to eliminate the tax incentive for hostile "junk bond" acquisitions without drastically altering current tax law rules relating to leveraged acquisitions in general. That section would add new Section 279A to the Code, which would disallow interest deductions on "hostile acquisition indebtedness." Hostile acquisition indebtedness is any "junior obligation" issued after February 18, 1985, in connection with a "hostile acquisition." A junior obligation is a debt obligation issued in connection with a corporate acquisition in defined circumstances indicative of legal or practical subordination. A "hostile acquisition" is a described form of acquisition not approved by the majority of the independent members of the board of directors of the target corporation.

In effect, new Section 279A would treat "junk bonds" issued in hostile takeovers in a manner consistent with their economic status as risk capital. To the extent that there was adequate capital to support the economic status of such "junk bonds" as true debt, there might be an argument for conferring true debt status on such obligations. Accordingly, it might be sensible to modify H.R. 1100 to incorporate some type of threshhold debt-equity test.

(5) It is quite true, as recently noted by the Joint Committee of Taxation, that the problem of leverage in corporate acquisitions is an important subject which deserves further consideration. See, Joint Committee on Taxation, Federal Income Tax Aspects of Mergers and Acquisitions (JCS-6-85), March 29, 1985. The enactment of new Section 279A would not preclude such a broader inquiry. It would, however, act as a deterrent to highly leveraged hostile junk bond takeovers pending such broad reconsideration. For this reason, I believe it is worth serious consideration at the present time.

Yours truly,

Peter C. Canellos

PCC/pl

TAX FORUM

No. 419

THE OVER-LEVERAGED ACQUISITION

PETER C. CANELLOS

April 1, 1985

THE OVER-LEVERAGED ACQUISITION*

There has been a pronounced shift from equity to debt financing in virtually all lines of business, in public as well as private companies. The trend is most evident in the proliferation of highly leveraged corporate acquisition transactions. Leveraged acquisition transactions take various forms but their common denominator is a large-scale substitution of debt for equity in the capital structure of the acquired entity.

Current tax rules provide a major incentive for highly leveraged acquisitions. As discussed below, the lack of a clear distinction between debt and equity under current law has permitted highly leveraged acquisitions to be consummated with little tax risk. The absence of tax law constraints on highly leveraged acquisitions in effect sanctions unrestricted *ad hoc* integration of corporate and shareholder taxation. If permitted to continue unabated, the growing trend toward leveraged acquisitions threatens to undermine the corporate income tax.

Contrary to popular thought, it does not appear that highly leveraged acquisitions necessarily face any insuperable economic or tax law constraints. Therefore, legislative action may be necessary if these transactions are to be restrained. To be effective, the legislative response

* The author gratefully acknowledges the assistance of Karen G. Krueger, an associate with the firm of Wachtell, Lipton, Rosen & Katz.

would deal directly with the underlying problem -- excessive leverage -- rather than attempting to distinguish debt from equity in all contexts.

The Leveraged Acquisition Movement

Even a casual perusal of business periodicals such as Mergers & Acquisitions and The Journal of Buyouts & Acquisitions makes it plain that there has been strong growth in the leveraged acquisition business. What has in the past been a narrow specialty principally within the control of relatively few leveraged buyout investment banking firms has spread far wider. It is now commonplace to encounter leveraged buyouts of corporate divisions or subsidiaries; friendly leveraged buyouts of public and private corporations; and, most recently, hostile "junk bond" leveraged acquisitions.

The increase in the volume of leveraged acquisition transactions has engendered considerable concern in the business community, the SEC, the Federal Reserve Board and Congress. In November of 1984, the Congressional Research Service issued a report entitled Merger Activities and Leveraged Buyouts: Sound Corporate Restructuring or Wall Street Alchemy.[1] This report summarizes a number of recent leveraged buyouts; examines some of the reasons for these transactions, including

1. Congressional Research Service, 98th Cong., 2d Sess., Merger Activity and Leveraged Buyouts: Sound Corporate Restructuring or Wall Street Alchemy? (Comm. Print 1984) [hereinafter cited as Merger Report].

tax motivation; and raises certain policy questions with regard to leveraged buyouts. Moreover, after a spate of large public leveraged buyout transactions in the spring of 1984, Business Week,[2] Forbes[3] and Dun's Business Month[4] all published articles dealing with these transactions and their inherent risks. These articles described the history of the leveraged buyout phenomenon and raised particular concern regarding the entry of new financing parties into the leveraged buyout market. The thrust of these articles is that new, less experienced players are driving up the price of leveraged acquisitions to the point where they may well be uneconomical. The articles also raise the spectre of rising interest rates causing the collapse of leveraged buyouts financed on a floating rate basis.[5]

2. Leveraged Buyouts: How Real Are the Dangers?, Bus. Wk., July 2, 1984, at 72.

3. Luring Banks Overboard?, Forbes, April 19, 1984, at 39.

4. Why Leverage Buyouts Are Getting Riskier, Dun's Bus. Month, April 1984, at 33.

5. See also Letter from Paul A. Volcker to the Hon. Walter E. Fauntroy (March 1, 1985) (expressing concerns about the potential risks of highly leveraged mergers and takeovers); John S.R. Shad, "The Leveraging of America," Address to the New York Financial Writers, June 7, 1984, reprinted in 1984 Fed. Sec. L. Rep. (CCH) ¶ 83,634, quoted in 16 Securities Regulation & Law Report 1038 (1984) ("Major bankruptcies 'have resulted from the heavy debt incurred by companies engaged in aggressive acquisition programs,' Shad observed. The 'leveraging up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates.'").

Despite these concerns, the leveraged acquisition phenomenon has continued virtually unabated. Since the publication of these articles, many large leveraged acquisitions have taken place.[6] Indeed, recent developments have largely undermined the view that very large companies could not be the subject of leveraged acquisitions.

A major factor in the growth of leveraged acquisitions is the establishment of a number of leveraged buyout partnerships. These partnerships often raise equity and subordinated debt financing (or obtain commitments therefor) for use in connection with leveraged buyout transactions to be negotiated. This financing is available to provide seed money for leveraged buyouts put together by the specialized investment bankers that sponsor such funds. These large pools of mobile capital help to reduce the delays in-

6. See, e.g., The Continental Group, Inc., and Continental Merger Corp., Proxy Statement/Prospectus for Special Meeting of Shareholders To Be Held September 26, 1984 (August 27, 1984) (leveraged buyout via merger of the Continental Group into Continental Merger Corp., a wholly-owned subsidiary of Kiewitt-Murdock Investment Corp.); ARA Holding Company, ARA Acquiring Corp. and ARA Services, Inc., Schedule 13E-3 (Amendment No. 2) filed with the Securities and Exchange Commission on January 9, 1985 (leveraged buyout of ARA Services, Inc. by private investors); Denny's Inc., Proxy Statement (December 21, 1984) (leveraged buyout of Denny's by management and outside financial institutions); Coca-Cola Bottling Co. Consolidated, Form 8-K filed with the Securities and Exchange Commission on February 26, 1985, Item 2 (describing leveraged purchase of certain subsidiaries of Wometco Coca-Cola bottling Company).

herent in the leveraged acquisition transaction and thus make that form of transaction more competitive with other forms of acquisition. Also, certain investment banking houses, particularly Drexel Burnham Lambert, have developed a large market for "junk bonds" -- i.e., low-grade, high-yield subordinated debt issued in leveraged acquisitions as well as other transactions. The crucial role of junk bond financing is evident from the involvement of Drexel Burnham in most large recent leveraged acquisitions. Moreover, Drexel Burnham provides liquidity for this market by repackaging such junk bonds for resale after original issuance through high-yield bond trusts.

Leveraged acquisitions have also been facilitated by recent changes in the Internal Revenue Code of 1954, as amended (the "Code"), which have provided munificent tax benefits for the establishment of employee stock ownership plans ("ESOPs"). Thus, under Section 133 of the Code, which was added in the Tax Reform Act of 1984 (the "1984 Act"), a bank, insurance company or other corporation actively engaged in the business of lending money excludes from its gross income 50% of the interest it receives on a "securities acquisition loan" to an ESOP or related employer. That exclusion can have the effect of substantially reducing the borrowing costs of the leveraged acquisition. Assuming a 46 percent marginal tax rate, a full pass-through of the benefit of this

exclusion would result in interest being charged at approximately 70% of the rate normally charged in similar transactions. In a recent leveraged buyout of the Parsons Company ("Parsons"), Parsons was able to secure financing for its ESOP at 85% of its usual borrowing rate, which was used to help finance a tender offer made jointly with a wholly-owned subsidiary of Parsons for all publicly-held shares of Parsons.

In addition, under Section 404(k) of the Code, also added by the 1984 Act, a corporation is allowed a deduction for the amount of dividends paid on its stock held by an ESOP, provided that such dividends are redistributed to plan participants not later than 90 days after the close of the plan year. This provision in effect converts nondeductible dividends into tax-deductible compensation. The new provisions supplement the basic ESOP tax advantage: tax deductibility for contributions to the ESOP used to repay the principal of the borrowings used to fund the leveraged acquisition.[7]

7. Other ESOP benefits adopted by the 1984 Act include tax-free rollovers on the sale of stock to an ESOP under Section 1042 of the Code and the shifting of estate tax liability from a decedent to the ESOP-distributee under Section 2210 of the Code. These provisions appear to have been drafted in some haste and raise many interpretive questions. For example, it has been argued that the Section 1042 rollover (which, according to the relevant legislative history, was intended to apply to sales of closely held companies) may apply to the sale of a subsidiary of a public company. That argument may run afoul of technical as well as policy arguments since the stock sold to the ESOP must be "employer securities" as defined in Section 409(1) of the Code. Under Section 409(1) only readily tradable stock qualifies if any member of the controlled group which includes the employer has readily tradable stock.

The leveraged acquisition phenomenon in part reflects the general trend toward increased leveraging in the American economy. Thus, a recent study by the Congressional Research Service indicated that the debt-to-equity ratio for all manufacturing firms had increased from approximately 1/4:1 in 1960, to approximately 1/2:1 in the first half of 1982.[8] Some commentators have noted that the American economy has largely been underleveraged when compared to certain other countries.[9] However, leveraged acquisitions generally raise debt-to-equity ratios far higher than industry averages. The following chart from The Journal of Buyouts and Acquisitions shows particularly dramatic increases in leverage:

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8. Merger Report, supra n.1, at 23. It has been pointed out that there was a reduction in debt-equity ratios in 1984 attributable, however, not to a new equity (as opposed to debt) financing, but rather to a growth in retained earnings resulting from the strong business recovery. Weiss, The Healthiest Balance Sheet in Years, Bus. Wk., March 22, 1985, at 107. Of course, the tax law favors growth through retained earnings since the shareholder tax on such earnings is avoided thereby. See American Law Institute, Federal Income Tax Project: Subchapter C 356 (1982) [hereinafter cited as ALI Study].

9. Roundtable: The Leveraged Buyout Market, Mergers & Acquisitions, Summer 1984, at 26, 31; cf. Tamari, Equity Financing and Gearing in the U.K., U.S., Japan, and Israel, 21 Management Int'l Rev. 80, 83 (1981) ("Table 1 shows that . . . British and American firms have less gearing [i.e., leverage] than those in Israel and Japan.")

Debt/Capitalization Ratios for
Selected Leveraged Buyouts

Company	Principal Industry	After LBO	Before LBO	1983 Industry Average
Albany International	Industrial Fabrics	0.84	0.26	0.23
Dillingham Corporation	Construction	0.84	0.23	0.29
Raymond International	Construction Engineering	0.82	0.25	0.29
Graniteville	Consumer Fabrics	0.71	0.34	0.23
Signode	Industrial Strapping	0.94	0.06	0.29
Tannetics	Beverage Dispensing Equipment	0.90	0.36	0.29 [10]

Moreover, the Congressional Research Service report previously cited refers to leveraged buyouts involving debt-to-equity ratios of as much as 12:1.[11] These ratios far exceed typical debt-to-equity ratios in the industries involved. These over-leveraged buyouts occur or are proposed with great frequency. In the absence of effective tax or other limitations on these transactions, there is no reason to expect that they will not continue on an accelerated basis.

10. Golden Management Buyouts: An Attractive Divestiture Option, J. Buyouts and Acquisitions, January 1985, at 3, 6.

11. Merger Report, supra n.1, at 22-23; see also description of buyout of NI Industries by KKR, Luring Banks Overboard, supra n.28 at 42; Miller, What's Next for Leveraged Buy-outs?, Institutional Investor 97,101 (November 1983).

The Form of the Leveraged Acquisition

Leveraged acquisitions vary in form depending upon the business to be acquired, the sources of financing, and the tax and business objectives of the acquirors.[12] For purposes of this discussion, however, it may be useful to focus on a typical form of "friendly" leveraged buyout transaction and a "junk bond" hostile acquisition.

A. Friendly Leveraged Buyout

The most common form of leveraged buyout is the friendly leveraged buyout of a division, subsidiary, or public or private company. This form of transaction typically involves the creation of an acquiror corporation ("Acquiror") and, in so-called "two-tier" structures, its wholly-owned dummy subsidiary ("Subsidiary"). Acquiror is usually established by the investment banker or other principals in the transaction. It has nominal capitalization until the consummation of the acquisition transaction. Contemporaneous with the acquisition, certain investors make equity contributions to Acquiror. In many cases, these acquisitions take

12. See generally Davis, Leveraged Buyouts: Selected Issues --Pre-and Post-TEFRA, 41st Annual NYU Inst. on Fed. Tax. 8-1 (1983); Daitz et al., Leveraged Buy-Outs in Acquisitions and Mergers 1984: Tactics and Techniques 277 (PLI) (1984); Levin, Tax Aspects of Leveraged Acquisitions in Leveraged Acquisitions: Private and Public 87 (PLI 1984); Kaufman et al., Leveraged Buyouts and Other Asset-Oriented Transactions in Acquisitions and Mergers: Tactics and Techniques 1983 411 (PLI) (1983).

the form of a "rollover" of the stock of the target corporation ("Target"). Management is also generally permitted to buy stock in Acquiror. Acquiror may also issue stock to financing parties and to the investment banker structuring the transaction.

The bulk of the acquisition financing is typically extended by banks to Acquiror (in a one-tier model) or to Subsidiary in a two-tier model. This financing is usually in the form of revolving credit or term loans amortizing over a period typically not in excess of 10 or 12 years. Very often, the interest rate on the bank debt floats with prime or another index. On occasion, fixed rates will be locked in through an interest rate swap or other arrangement.

In many cases, the funds lent by the banks and obtained through the issuance of Acquiror stock are insufficient to pay for the acquisition. In these cases, additional "mezzanine" financing is required. The mezzanine financing typically consists of subordinated debt of Acquiror or Subsidiary. On occasion, part or all of the mezzanine financing will be represented by preferred stock rather than subordinated debt. Often, the mezzanine financing is sold to institutions as part of a "strip," the other elements of which consist of senior debt of the type sold to the banks and/or the common stock of Acquiror.[13]

13. See Luring Banks Overboard, supra n.3 at 41, 43; Merger Report, supra n.1, at 14-15; Miller, What's Next For Leveraged Buyouts?, Institutional Investor, November 1983 at 97.

The acquisition is usually consummated through the merger of Subsidiary (or Acquiror) into Target. On that merger, the non-continuing shareholders of Target receive taxable consideration for their shares and the shares of the merged company become all of the stock of the surviving corporation. Under well established tax principles, the merger company's existence is disregarded and the merger transaction is given the tax effect which it would have if not accomplished through the medium of a merger.[14] Accordingly, to the extent that the consideration received in the merger by Target shareholders consists of securities of Target as survivor of the merger (or the proceeds of the bank borrowings by Subsidiary which are assumed by Target on the merger), the transaction is considered a redemption.[15] For the Target shareholders who terminate their equity interest in Target as the result of the merger, the redemption qualifies for capital gain or loss treatment under Section 302. To the extent that the consideration is derived from equity or debt issued by Acquiror, the transaction should probably be viewed, pro-tanto, as a purchase of Target stock.[16]

A growing trend in leveraged acquisitions of public companies is the issuance of junior subordinated debentures

14. Rev. Rul. 67-448, 1967-2 C.B. 144.

15. See Rev. Rul. 78-250, 1978-1 C.B. 83.

16. See Rev. Rul. 73-427, 1973-1 C.B. 301; Private Letter Rulings 8350057, 8226072.

to Target shareholders in the acquisition transaction. The subordinated debentures are "junk bonds" that are not rated as investment grade by either Moody's or Standard & Poors. In effect, the junk bonds supply a cushion minimizing the risk to the bank lenders (and, in some cases, third-party mezzanine lenders who receive senior subordinated or unsubordinated debentures). In such a transaction, the Target shareholders retain much of the downside risk of equity owners since they typically do not enjoy the benefit of a large equity cushion under their investment.

A particularly striking form of such a transaction involves the issuance of zero coupon or deferred interest debentures to the Target shareholders. By providing for no interest until maturity or by skipping interest for a number of years, cash is retained in the corporation which is available for corporate purposes, including payment of senior debt service. Under Section 1272 of the Code, original issue discount deductions are generated in an amount equal to the adjusted issue price of the debentures multiplied by their yield to maturity. In the case of debentures providing for interest payments to commence after a period of years, the instrument is treated as a "serial maturity" obligation bearing original issue discount.[17]

17. See Metromedia, Inc., Proxy Statement/Prospectus, May 21, 1984, at 41-43; Canellos & Kleinbard, The Miracle of Com-

(footnote continued)

The original issue discount generated by the issuance of such instruments provides a tax shield which permits the payment of principal on senior debt (as well as other nondeductible cash expenditures) out of pre-tax dollars. Of course, there will be a corresponding nondeductible cash payment at maturity on the discount debenture. The risk of insufficient pre-tax cash flow to pay off the debt at maturity is considerably mitigated by the continuing role of the General Utilities[18] doctrine under current law. Thus, if after-tax cash flow is unexpectedly not available to pay the discount debt at maturity, the issuer can sell its assets under a Section 337 plan of liquidation and pay off such debt in pre-tax dollars. The net result in such case would be that operating earnings would be sheltered by discount deductions and pre-tax gain would be available to repay debt at maturity -- a double tax benefit.

B. The Hostile "Junk Bond" Acquisition

Most leveraged buyouts are accomplished on a friendly basis involving negotiation between Target and

(footnote continued)

pound Interest: Interest Deferral and Discount After 1982, 38 Tax L. Rev. 565, 567-71 (1983). Interestingly, the Metromedia leveraged buyout in June of 1984 was followed in November of 1984 by a second "junk-bond" financing that retired the bank debt issued in the leveraged buyout.

18. See General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). Of course, General Utilities also can shelter repayment of principal out of tax-exempt liquidation gain.

Acquiror. Where Target management will have a substantial involvement in Acquiror, the transaction must, in the case of a public transaction, be reviewed by an independent committee of the Board of Directors, which is typically represented by its own investment bankers and counsel.[19] In recent years, however, there has developed another form of leveraged acquisition which is pursued despite the opposition of Target management and Target's Board of Directors. This is the "junk bond" "bust up" takeover.[20] This form of transaction has played a part in some of the largest corporate acquisitions in history.[21] Although many of these proposed transactions have not succeeded, they have posed a substantial threat to the companies in question, which has often caused those companies to pursue alternative transactions.

The junk-bond hostile offering has been described as follows:

> The buyer sets up a new company on paper. Drexel creates a package of junk bonds to be issued by the

19. See generally 17 C.F.R. § 240-13e-3 (1984); see also Lederman, Citron & Macris, Leveraged Buyouts -- An Update in Fifteenth Annual Institute on Securities Regulation 281 (PLI 1983), 295-99; Daitz, supra n.12 at 327-48.

20. See Lipton, Greenmail, Bust-Up Takeovers -- A Discussion Memorandum, New York Law Journal, September 7, 1984 at 1; see also Drexel's "Junk-Bond Bust-Up Takeover" Seen as Replacing "Two-Tier Bootstrap Bust-Ups," 1 Corporate Control Alert, September 1984 at 9.

21. See James J. Hayes and James H. McElroy, Schedule 14 D-9 filed with the Securities and Exchange Commission on March 30, 1984 (subject company, Gulf Corporation).

> paper company once it gains control through a tender offer. Then Milken and his 125-person staff contact junk-bond investors, seeking advance commitments to buy the bonds. Once in control, the raider can raise cash by selling off pieces of his new property. "We take a minnow, identify a whale, then look to its assets to finance the transaction," explains Michael D. Brown, Drexel's West Coast merger chief.[22]

The junk bond hostile offering typically takes place in a number of stages. For purposes of illustration, we will examine the proposed acquisition of Phillips Petroleum by Carl Icahn and his affiliates. This proposed transaction, which surfaced in February of 1985, was ultimately not consummated.[23]

The Icahn offer for Phillips changed over time. In basic outline, however, it contemplated a hostile tender offer for 51% of the Phillips stock to be followed by a second-step merger. The tender offer required approximately $4.3 billion. Icahn proposed to raise this financing through the issuance of several series of debt and equity instruments

22. Bianco, How Drexel's Wunderkind Bankrolls the Raiders, Bus. Wk., March 4, 1985 at 90, 90-91.

23. See Icahn Group, Inc., Offer to Purchase for Cash 70,000,000 Shares of Common Stock of Phillips Petroleum Company at $60.00 Net Per Share (February 13, 1985) [hereinafter cited as Icahn Offer].

of a newly-established dummy corporation. In one of the variations, the following instruments were to be issued by the dummy corporation:

Security	$ Millions
Floating Rate Senior Notes	$1,998
Senior Subordinated Debentures	2,000
Preferred Stock	600
Common Stock	400
Total	$4,998

The Icahn offer contemplated that, after the tender offer, the dummy corporation would be merged into Phillips, with the Phillips' stockholders receiving junior subordinated debentures of the survivor aggregating approximately $3.8 billion.

Icahn indicated that, although his offer was conditioned on raising the requisite financing, his investment banker, Drexel Burnham Lambert, was "highly confident" that such financing could be raised on certain assumptions. The feasibility of such financing became a major item in the litigation between Icahn and Phillips. Whether or not raising that financing would ultimately have proved feasible is open to question. An examination of the form of financing, however, is quite instructive in analyzing the hostile "junk bond" form of transaction.

The financing for the tender offer involved instruments having different relative rights and different interest

and dividend rates. All the debt instruments involved, however, in effect amounted to "junk bonds" since the dummy corporation had little equity to support them and since they would rank behind approximately $3.2 billion of existing Phillips long-term debt. These junk bonds were expected to be issued to regular financing sources of Drexel Burnham. The risks inherent in the purchase of these instruments were considerably mitigated since they would not be issued until after Icahn had succeeded in obtaining 51% of the Phillips stock through a tender offer. In fact, these instruments were not to be issued until there remained no real barrier to the merger between Icahn's dummy subsidiary and Phillips. In effect, these parties were expecting that, if they in fact had to fund pursuant to their commitments, their claims would be taken over by Phillips as the result of the contemplated merger.

In the contemplated merger, as noted above, the Phillips shareholders whose shares were not purchased in the tender offer would have received junior subordinated debentures. In effect, these junior subordinated debentures, which would be inferior in rank to all the instruments issued by Icahn's dummy subsidiary other than preferred stock and common stock, would supply a cushion under the first junk bond financing issued to consummate the tender offer. Upon the merger of

the Icahn dummy subsidiary with Phillips, the survivor was expected to have a balance sheet along the following lines:

Phillips historic long-term debt	$3.2 billion
Icahn senior floating-rate acquisition indebtedness	2.2 billion
Icahn senior subordinated acquisition debt	2.0 billion
Public junior subordinated debt	3.9 billion
Preferred stock	0.6 billion
Common stock	0.2 billion

This would have left Phillips with a debt-to-equity ratio of over 14:1. This is far higher than the debt-to-equity ratio of any major integrated oil company. In the opinion of Phillips management, this acquisition would have been tantamount to requiring a liquidation of the company.

The Icahn offer for Phillips was ultimately defeated. The result was, however, an exchange offer pursuant to which Phillips acquired approximately 47% of its outstanding stock for senior and subordinated debt. This left Phillips with a debt-to-equity ratio of approximately 3:1, again much higher than industry averages, but far lower than that contemplated by the Icahn offer.[24]

One lesson of the Icahn-Phillips episode is that even a nominally capitalized acquiring company, financed principally through an expectation of the issuance of junk

24. See Phillips Petroleum Company, Offer to Purchase up to 72,580,000 Shares of its Common Stock (March 4, 1985).

bonds, can pose a serious threat to a giant corporation. Part of the effectiveness of this threat is attributable to securities laws which make a two-tiered offer of this type quite powerful.[25] For purposes of this article, however, its significance lies in the fact that, if successful, the transaction would have resulted in an extremely highly leveraged corporation. The high leverage involved in such a transaction would have had obvious business effects. But one of the most important effects would have been drastic reduction in the Federal income tax liability of the surviving corporation. Based upon the deductions likely to be generated by the new indebtedness put on the Phillips balance sheet, as much as $600 million per year in tax savings would have resulted. It is this consequence of high leverage that requires an examination of the tax rules in this area.

Tax Benefits of Leverage: The Interest Deduction

The major tax benefit associated with high leverage in acquisition transactions is the tax deductibility of interest. As has often been noted, the double tax corporate system puts a premium on issuing debt rather than equity. The premium is magnified in a leveraged buyout where an existing

25. See Lederman & Vlahakis, Pricing and Proration in Tender Offers, 14 Rev. Sec. Reg. 813 (1981); Lipton & Steinberger, Takeovers and Freezeouts § 1.07[4][c] (1984 ed.).

profitable business is typically acquired, largely through the substitution of debt for equity in the capital structure of such corporation.

In most leveraged buyouts the candidate is a corporation which enjoys steady cash flow and is often a high effective-rate taxpayer. The leveraged buyout channels this cash flow to pay off the fixed obligations incurred to acquire the business. Through tax deductions for interest (supplemented in some cases by enhanced depreciation resulting from a stepped-up basis) the buying group attempts to use pre-tax cash flow to the maximum extent. In such a case the United States government in effect finances a large part of the purchase price through the tax law.[26]

Apart from this truism, there are certain additional considerations of substance. First, if some leverage is good, a high degree of leverage is even better. In most leveraged buyouts, virtually all available cash is used to retire the acquisition financing. It is the goal of most leveraged buyouts to assure that such payments are virtually all in the form of deductible interest and payment of principal on indebtedness rather than distributions on or in redemption of stock. Second, the constraints on leverage are

26. See Luring Banks Overboard?, supra n.2B, at 39-41; Merger Report, supra n.1, at 22-26.

not necessarily limited by the availability of current cash flow to meet debt service requirements. To the extent that acquisition indebtedness can be structured as zero coupon bonds, interest deductions are generated in excess of cash available for distribution. In effect, as previously noted, interest deductions are generated for what may well represent ultimate liquidation value of the enterprise at the time the zero coupon comes due. If there is likely to be sufficient liquidation value to support repayment of the zero-coupon bonds at maturity, they may have the required value to support the transaction even though the target business does not generate sufficient current operating earnings and cash flow to cover a current-interest paying bond of equivalent value. Third, business considerations very often do not stand in the way of high leverage. If financing is to be raised through the issuance of preferred stock (the typical alternative to subordinated debt), the pre-tax economics and cash flow can be modeled virtually precisely to match the pre-tax economics and cash flow in connection with the issuance of subordinated debt. The major difference between subordinated debt and preferred stock becomes clear only after an examination of the after-tax consequences.

The power of high leverage in a corporate acquisition transaction is best illustrated through a simple but not

unrealistic example. Assume that Target has a book and fair market value net worth of $100 million. It has no debt and no preferred stock outstanding. Its business generates an annual pre-tax return of 20% (compounded semi-annually), and Target pays current taxes at a 50% tax rate. Thus, absent an acquisition transaction, Target would be expected to generate in the current year $21 million of net pre-tax income and pay $10.5 million in taxes. Accordingly, at the end of the current year, absent the acquisition transaction, Target's net worth would grow to $110.5 million.

Let's examine the results where Target is acquired in one of four possible acquisition transactions.

Transaction 1: This involves a purchase of Target for $100 million, financed through the issuance of $45 million in bank debt bearing 12% interest payable in a bullet maturity in 10 years; $45 million in subordinated debt bearing interest at 16% payable in a bullet maturity in 20 years; and $10 million in common stock (i.e., a 9:1 debt equity ratio).

Transaction 2: The facts are the same as Transaction 1 except that the purchase price is financed through the issuance of $45 million in bank debt of the type described; $45 million of a preferred stock paying a

14% current coupon redeemable in the twentieth year;[27] and $10 million in common stock.

Transaction 3: Again, the same as Transaction 1, except that the acquisition price is financed through $45 million in bank debt on the terms described and the issuance of a zero coupon bond for $45 million maturing (at a price of $977,603,467) in 20 years and having a yield to maturity of 16%.

Transaction 4: Again the same as Transaction 1, except that the financing consists of $45 million of bank debt as described and the issuance for $45 million of a "discount" preferred stock redeemable in 20 years at a price ($673,850,603) which generates a 14% yield to maturity. (This redemption premium would presumably be accruable as dividend income under § 1.305-5 of the Regulations.)

The differences in the after-tax cash flows in these transactions are summarized in the table below.

27 While it might be thought that the preferred stock should yield considerably less than 14% because of the dividends received deduction, in fact, in a highly leveraged corporation a spread of only 2 percentage points between preferred stock and subordinated debt is realistic. In the Icahn-Phillips transaction, for example, the preferred stock was to yield 15% and the subordinated debt 16%. See Icahn Offer, supra n.23.

Transaction 1

Year	Income Before Interest Expense	Tax	Debt Service	Residual Equity
1	15,600,000	4,200,000	12,600,000	104,200,000
2	16,482,000	4,641,000	12,600,000	108,841,000
3	17,456,610	5,128,305	12,600,000	113,969,305
4	18,533,554	5,666,777	12,600,000	119,636,082
5	19,723,577	6,261,789	12,600,000	125,897,871
6	21,038,553	6,919,276	12,600,000	132,817,147
7	22,491,601	7,645,800	12,600,000	140,462,948
8	24,097,219	8,448,610	12,600,000	148,911,557
9	25,871,427	9,335,714	12,600,000	158,247,271
10	27,831,927	10,315,963	57,600,000	123,563,234
11	25,948,279	9,374,140	7,200,000	132,937,374
12	27,916,848	10,358,424	7,200,000	143,295,798
13	30,092,118	11,446,059	7,200,000	154,741,857
14	32,495,790	12,647,895	7,200,000	167,389,752
15	35,151,848	13,975,924	7,200,000	181,365,675
16	38,086,792	15,443,396	7,200,000	196,809,071
17	41,329,905	17,064,953	7,200,000	213,874,024
18	44,913,545	18,856,773	7,200,000	232,730,796
19	48,873,467	20,836,734	7,200,000	253,567,530
20	53,249,181	23,024,591	52,200,000	231,592,121

Transaction 2

Year	Income Before Interest Expense	Tax	Debt Service	Preferred Dividend	Residual Common Equity
1	15,600,000	7,800,000	5,400,000	6,300,000	101,500,000
2	15,915,000	7,957,500	5,400,000	6,300,000	103,157,500
3	16,263,075	8,131,538	5,400,000	6,300,000	104,989,038
4	16,647,698	8,323,849	5,400,000	6,300,000	107,012,887
5	17,072,706	8,536,353	5,400,000	6,300,000	109,249,240
6	17,542,340	8,771,170	5,400,000	6,300,000	111,720,410
7	18,061,286	9,030,643	5,400,000	6,300,000	114,451,053
8	18,634,721	9,317,361	5,400,000	6,300,000	117,468,419
9	19,268,367	9,634,183	5,400,000	6,300,000	120,802,597
10	19,968,545	9,984,273	50,400,000	6,300,000	79,486,870
11	16,692,243	8,346,121	0	6,300,000	81,532,991
12	17,121,928	8,560,964	0	6,300,000	83,793,955
13	17,596,731	8,798,365	0	6,300,000	86,292,320
14	18,121,387	9,060,694	0	6,300,000	89,053,014
15	18,701,133	9,350,566	0	6,300,000	92,103,580
16	19,341,752	9,670,876	0	6,300,000	95,474,456
17	20,049,636	10,024,818	0	6,300,000	99,199,274
18	20,831,848	10,415,924	0	6,300,000	103,315,198
19	21,696,192	10,848,096	0	6,300,000	107,863,294
20	22,651,292	11,325,646	0	6,300,000	112,888,940
Redemption of Preferred Stock					(45,000,000)
					67,888,940

Transaction 3

Year	Income Before Interest Expense	Tax	Debt Service	Residual Equity
1	15,600,000	4,056,000	5,400,000	111,544,000
2	18,024,240	4,645,119	5,400,000	124,923,122
3	20,833,856	5,323,257	5,400,000	140,433,720
4	24,091,081	6,104,283	5,400,000	158,420,518
5	27,868,309	7,004,272	5,400,000	179,284,555
6	32,249,757	8,041,863	5,400,000	203,492,448
7	37,333,414	9,238,678	5,400,000	231,587,184
8	43,233,309	10,619,801	5,400,000	264,200,692
9	50,082,145	12,214,344	5,400,000	302,068,493
10	58,034,384	14,056,095	50,400,000	301,046,782
11	63,219,824	14,159,289	0	350,107,318
12	73,522,537	16,406,861	0	407,222,994
13	85,516,829	19,017,034	0	473,722,788
14	99,481,786	22,048,946	0	551,155,628
15	115,742,682	25,571,455	0	641,326,855
16	134,678,639	29,664,732	0	746,340,762
17	156,731,560	34,422,142	0	868,650,180
18	182,416,538	39,952,409	0	1,011,114,309
19	212,344,005	46,382,168	0	1,177,066,147
20	247,183,891	53,858,914	977,603,467	392,787,657

Transaction 4

Year	Income Before Interest Expense	Tax	Debt Service	Residual Common Equity
1	15,600,000	7,800,000	5,400,000	107,800,000
2	17,238,000	8,619,000	5,400,000	116,419,000
3	19,047,990	9,523,995	5,400,000	125,942,995
4	21,048,029	10,524,014	5,400,000	136,467,010
5	23,258,072	11,629,036	5,400,000	148,096,046
6	25,700,170	12,850,085	5,400,000	160,946,130
7	28,398,687	14,199,344	5,400,000	175,145,474
8	31,380,550	15,690,275	5,400,000	190,835,749
9	34,675,507	17,337,754	5,400,000	208,173,502
10	38,316,436	19,158,218	50,400,000	182,331,720
11	38,289,661	19,144,831	0	201,476,551
12	42,310,076	21,155,038	0	222,631,589
13	46,752,634	23,376,317	0	246,007,906
14	51,661,660	25,830,830	0	271,838,736
15	57,086,135	28,543,067	0	300,381,803
16	63,080,179	31,540,089	0	331,921,892
17	69,703,597	34,851,799	0	366,773,691
18	77,022,475	38,511,238	0	405,284,929
19	85,109,835	42,554,918	0	447,839,846
20	94,046,368	47,023,184	0	494,863,030
Redemption of Preferred Stock				(673,850,603)
				(178,987,573)

The striking fact is that at the end of 20 years, the net worth allocable to the common stock, after repayment of all fixed charges, is as follows:

Transaction 1: $231,592,121

Transaction 2: 67,888,940

Transaction 3: 392,787,657

Transaction 4: -178,987,573 (i.e., $673,850,603 is payable on the redemption of the preferred stock, but there is only $494,863,030 in corporate assets).

This example demonstrates the compound interest power of leverage. Absent tax law constraints, there is an overwhelming advantage in using Transaction 1 rather than Transaction 2, and Transaction 3 rather than Transaction 4.

Other Tax Aspects of Leveraging

As discussed above, the overwhelming tax consideration in high leverage is the tax deductibility of interest. Other incidental consequences discussed below may also have substantial significance in a particular acquisition transaction.

1. Principal Repayment. Since most leveraged acquisitions result in the business being conducted by a corporation which is closely held, payments made to the

shareholders of such corporation in respect of their equity investment risk dividend treatment. For example, it holders of common stock also buy preferred stock, redemption of that preferred stock (without concurrent redemption of common) might well generate a dividend unless the transaction could be brought within Section 302(b)(1) of the Code. Obviously, repayment of principal does not raise that dividend question. This factor is somewhat mitigated, as to non-controlling shareholders, by the Internal Revenue Service's liberal position under Section 302(b)(1).[28]

2. Investor Rollovers. In many leveraged acquisitions, shareholders of Acquiror may include former shareholders of Target. Such Target shareholders frequently wish to cash in part of their investment in Target on a capital gains basis and roll over their remaining Target investment on a tax-free basis.

A typical format for accomplishing that goal is for such Target shareholders to contribute some of their Target shares to Acquiror for Acquiror stock followed by an exchange of their remaining shares for cash or debt securities in the ensuing merger of Acquiror or its subsidiary into Target. Under published rulings the exchange in the merger is treated

28. Rev. Rul. 76-385, 1976-2 C.B. 92.

as a redemption.[29] The contributing Target shareholders would have capital gain rather than dividend income on the receipt of cash for their remaining shares pursuant to the merger if the deemed redemption transaction qualified, as to them, under one of the tests set forth in Section 302(b) of the Code.[30]

The existence of high leverage in the acquisition transaction facilitates the extraction of relatively large amounts of cash from Target by Target shareholders continuing an equity interest in Target. For example, assume Target

29. Rev. Rul. 78-250, supra n.15.

30. There are several other methods to accomplish the desired result. First, in a two-tiered model, the continuing shareholders could transfer all their Target shares to Acquiror for a package of stock and debt or cash. They would argue that this transaction amounts to a Section 351 incorporation with boot resulting in capital gain to the extent of the boot. Section 304 arguably would not come into play if the continuing shareholders own less than 50% of Target or receive less than 50% of Acquiror. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 5-10 (1979 ed. Special Supp. 1982). There is some question however, whether the other shareholders of Target who receive only cash or debt should count under the first 50% test. Ginsberg, Taxing Corporate & Acquisitions, 38 Tax L. Rev. 171, 179-81 (1983); Leveraged Corporate Buyout May Be Denied Asset Basis Step-up, 25 Tax Management Memorandum 337 (1984) (IRS is considering its interpretation of Section 304(c)(2)(B) and may issue new regulations thereunder). The Section 351 approach also allows for the receipt of debt securities on a non-recognition basis. Second, the continuing Target shareholders might sell some of their Target shares before the deal becomes final (which raises security law issues) or might sell some Target or Acquiror shares to their new co-investors in Acquiror.

is worth $100 million, has no debt, and has 10 shareholders each holding 10% of the stock worth $10 million. All the shareholders but one are to be redeemed in full, with the continuing shareholder ("A") wishing to cash in 2% of his 10% interest. In this case, A would have to wind up with less than 8% of Target to qualify under Section 302(b)(2). If new shareholders acquire newly-issued shares of Target equal to all the shares redeemed from old shareholders the continuing shareholder can meet this test. (Under Revenue Ruling 75-447,[31] the transaction would be judged under the principle of Zenz v. Quinlivan,[32] in determining the selling shareholder's status under Section 302(b)(2).[33]) This would leave A with $2 million in cash and 8% interest in the survivor. In a leveraged format, however, A can receive more cash or debt of Target while still maintaining the maximum equity position he would be entitled to maintain consistent with satisfying Section 302(b)(2) of the Code. Suppose, for example, that A and outside investors form NewCo

31. 1975-2 C.B. 113.

32. 213 F.2d 914 (6th Cir. 1954).

33. In that connection, Professor Coven comments that Revenue Ruling 75-447 should as a matter of policy be limited to disregard the effect of "fresh investment" in the surviving company resulting from the redemption transaction. Coven, The Relevance of Fresh Investment to the Characterization of Corporate Distributions and Adjustments, 38 Tax L. Rev. 419. That is generally not a problem in a leveraged acquisition in which there is typically disinvestment rather than fresh investment.

to merge with Target. NewCo borrows $90 million, which is used to redeem the other nine Target shareholders in the merger. In order to meet the test of Section 302(b)(2), as before, A must end up with no more than 8% of Target after the merger. However, that 8% will be worth only $800,000 because of the leveraged assumed in the merger. Thus, A can take an additional $7.2 million in the form of debt or cash from NewCo (or an aggregate of $9.2 million), since the Target stock he contributed was worth $10 million. In effect, leverage permits the investor in question to "sell" high value unleveraged shares and reinvest in low value leveraged shares, thus maximizing his cash withdrawal from the company.

3. Management Cheap Stock. An effect of high leverage is to reduce the book value attributable to the common stock of Acquiror. In a highly leveraged structure, Acquiror's common stock may have a nominal net worth. In fact, however, the common stock of Acquiror represents the possibilities for appreciation in the Target business in excess of such appreciation as is required to repay all fixed obligations. In this respect, the Acquiror common stock has a strong "option" element.

It is very common in leveraged acquisitions to permit management to purchase a large part of the common stock

of Acquiror as an incentive. In an unleveraged structure, the acquisition of a substantial common stock position would either require management to come up with substantial equity investment (generally beyond their means) or to receive stock as compensation, whether in restricted form or otherwise.

Once a high degree of leverage is injected into the transaction, however, management can purchase leveraged stock at its book value, which it would be argued is its fair market value. Assuming the stock is not subject to forfeiture restrictions or, if it is, that an election is made under Section 83(b) of the Code, management is in the position to avoid ordinary income in respect of this purchase of common stock.

Of course, this arrangement is subject to attack on several theories. First, it may be argued that the common stock is really worth more than its book value, and thus a purchase at book is a bargain purchase. Second, it might be argued that the highly leveraged common stock really represents a non-qualified stock option subject to § 1.83-7 of the Regulations. That is analogous to the position taken by the Internal Revenue Service in connection with "junior stock" arrangements.[34] While these potential attacks raise

34. See Private Letter Ruling 8329091; Private Letter Ruling 7926020.

a theoretical risk, in practice this compensation issue appears to be largely ignored in leveraged acquisition transactions.

4. Permitting Loss Recognition to Seller. Where a corporate seller is divesting a division at a price less than the tax basis of the division's assets, the corporate seller generally wishes to recognize a taxable loss. Since the loss division very often cannot support adequate third-party financing to provide the desired purchase price, the seller often supplies purchase money financing. If that financing were provided in the form of preferred stock, the seller's loss would probably be disallowed under Section 351 of the Code on the theory that the seller corporation and Acquiror's shareholders were contributors to Acquiror in a Section 351 incorporation.[35] By taking back purchase money debt, the seller is in the position to avoid nonrecognition of loss under a published Internal Revenue Service ruling.[36]

5. Avoiding Section 304. Target shareholders wishing to maintain an equity position in Acquiror have to

35. See John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); Zilkha & Sons, Inc., 52 T.C. 607 (1969); Ragland Investment Co., 52 T.C. 867 (1969) aff'd, 435 F.2d 118 (6th Cir. 1970) Isidore Dobkin, 15 T.C. 31 (1950), aff'd, 192 F.2d 392 (2d Cir. 1951) (per curiam).

36. Rev. Rul. 73-472, 1973-2 C.B. 114.

avoid the strictures of Section 304 of the Code as amended by TEFRA and the 1984 Act and TEFRA. One means for avoiding Section 304 is to employ a two-tier model in which Acquiror winds up as a holding company and to make sure that former Target shareholders who are transferors to Acquiror receive less than 50% (by voting power and value) of all the stock of Acquiror. Obviously, if continuing Target shareholders were to take back preferred stock of Acquiror, such stock would have to be valued for purposes of the 50% test. By taking back debt instruments instead, that 50% threshold may be avoided.[37]

Existing Tax Law Constraints on Leverage

As demonstrated above, existing tax law provides a powerful incentive for high leverage. Under existing law, there are two basic weapons available to the Internal Revenue Service to combat highly leveraged acquisitions. First, the Internal Revenue Service may argue that some or all of the acquisition debt is equity for tax purposes. Second, the Internal Revenue Service may attempt to invoke Section 279 of the Code, which denies an interest deduction for certain types of corporate acquisition indebtedness but without re-characterizing such debt as equity. As discussed below,

37. See n.30 supra for discussion of ambiguity in Section 304 in this regard.

neither line of attack is likely to be fruitful in the typical highly leveraged acquisition.

A. Debt-Equity Issues

Professors Bittker and Eustice have referred to cases which deal with debt-equity issues as a "viper's tangle."[38] Indeed, after the hundreds of cases and professional articles dealing with the debt-equity distinction, it is impossible to draw any firm conclusion. However, the major grounds for attacking purported debt as equity do not apply to most leveraged acquisition transactions.

There is no case law to the author's knowledge which recharacterizes straight debt instruments (not involving hybrid features such as convertibility or participation in profits) as equity when held by non-shareholders. The absence of authority is manifest from the preamble to the first set of Section 385 Regulations which, in referring to "nominal equity" as a basis for challenging the status of non-shareholder debt as true debt, cited two cases involving shareholder-held debt.[39] Thus, even though debt

38. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 4-10 (1979 ed.).

39. Fed. Reg. 18957, 18962 (March 24, 1980) citing Isidore Dobkin, supra n.35, and George L. Sogg, 9 T.C. Memo. (CCH) 927 (1950), aff'd 194 F.2d 540 (6th Cir. 1952).

is subordinated and is supported by an inadequate equity cushion, it is not likely to be characterized as equity. Accordingly, a major element of leverage in acquisitions -- i.e., subordinated junk bonds issued to Target shareholders or new investors who do not acquire stock -- is probably not subject to recharacterization.

This conclusion probably remains valid even though, in the case of debt held by former shareholders, the bankruptcy law imposes certain equity features. Thus, if Target goes into bankruptcy, former shareholders may have to repay to Target payments received on Target debt instruments issued in the merger.[40] The preamble to the "final" Section 385 Regulations commented on this equity feature, but concluded that it was not a sufficient basis for recharacterization of the purported debt instruments for tax purposes.[41]

More fruitful challenges can be raised in the case of mezzanine debt sold in a "strip" with common stock. There are cases which would permit recharacterization of such debt as equity, particularly where the leverage is excessive.[42]

40. 11 U.S.C. §§ 548, 550; see also Smith, Shareholder Risks in Leveraged Buyouts Ride on Fear of Bankruptcy-Law Filings, The Wall Street Journal, July 25, 1984, at 18.

41. 45 Fed. Reg. 86438, 86439-86440 (December 31, 1980).

42. Isidore Dobkin, supra n.35; George L. Sogg, supra n.39; Dillin v. U.S., 70-2 USTC ¶ 9647 (5th Cir. 1970); McSorley's,

(footnote continued)

In addition, if the debt is convertible, or bears other hybrid features, the Internal Revenue Service may well argue for equity characterization.[43]

This pattern of the case law was largely followed in the final Regulations under Section 385, which were withdrawn after promulgation. As will be recalled, the first version of the Section 385 Proposed Regulations would have characterized as equity straight debt (even if not held proportionately with stock) if the issuer's debt-to-equity ratio exceeded 10:1. This approach would have put a serious crimp in highly leveraged acquisitions.[44] Commentators argued that many companies had debt-to-equity ratios in excess of 10:1.[45] In response to this contention, the

(footnote continued)

Inc. v. U.S., 63-1 USTC ¶ 9231 (D. Colo. 1962) aff'd, 63-2 USTC 9797 (10th Cir. 1963); Universal Castings Corp., 37 T.C. 107 (1961), aff'd, 303 F.2d 620 (7th Cir. 1962); Sam Schnitzer, 13 T.C. 43 (1949), aff'd, 183 F.2d 70 (9th Cir. 1950), cert. den., 340 U.S. 911 (1951); Swoby Corp., 9 T.C. 887 (1947); Joseph B. Thomas, 2 T.C. 193 (1943).

43. See Rev. Rul. 83-98, 1983-2 C.B. 40 (adjustable rate convertible note with "very high probability" of conversion recharacterized as equity); Taylor, Debt/Equity and Other Tax Distinctions: How Far Can We Go? 62 Taxes 848, 856-58.

44. Rosenbaum, Debt-Equity Classification under Tax Law: Relevant Considerations in Structuring a Leveraged Buyout, in Buyouts & Acquisitions at 37, 40 (Oct.-Nov. 1984).

45. See Beghe, Redrawing the Lines Between Corporate Debt and Equity Interests: The Proposed Regulations Under Section 385, 58 Taxes 931, 942-43 (1980); Beghe, An Interim Report On the Debt-Equity Regulations Under Code Section 385, 59 Taxes 203, 206 (1981); New York State Bar Tax Section, Report on Proposed Regs. § 1.385: The Tax Distinction Between Corporate Debt and Equity B-54 (1980).

Internal Revenue Service withdrew the section of the Proposed Regulations dealing with such excessively leveraged situations. Under the final Regulations, debt issued in a leveraged acquisition would be challenged only if it were held proportionately with a substantial class of stock or were a hybrid instrument with equity features whose value exceeded the value of the straight debt elements.

B. Section 279

In 1969, Congress, largely in response to concern over the conglomerate merger phenomenon, enacted both Section 385 authorizing debt-equity regulations and Section 279 applying restrictions on certain corporate acquisition indebtedness. In practice, Section 279 is easily avoided and rarely invoked by the Internal Revenue Service. The reasons for the limited role of Section 279 are quite clear. In order to be caught under Section 279, indebtedness must meet four separate tests:

(1) It must be issued to provide consideration for the acquisition of stock or assets of "another corporation";

(2) It must be either subordinated to the claims of trade creditors of the issuing corporation generally or expressly subordinated in right of payment to the

payment of any substantial amount of unsecured indebtedness of the issuing corporation;

(3) It must either be convertible into stock of the issuer or be issued as part of an investment unit which includes an option to acquire stock of the issuer; and

(4) On defined dates, the debt-to-equity ratio of the issuer must exceed 2:1 or its projected earnings must not exceed 3 times the annual interest to be paid or incurred.

Complicated Regulations under Section 279 spell out the meaning of many of these terms, particularly the application of the debt-to-equity ratio.

Virtually the only way to be caught by Section 279 is by blithely ignoring its provisions. In any leveraged acquisition, it is possible to avoid at least one of the four hooks involved in Section 279. Assuming a highly leveraged transaction, the debt-to-equity test will, of course, be flunked. However, the other three tests leave gaping holes for avoidance.

For example, Section 279 does not apply if the debt obligation is issued in redemption of stock of the issuer.

In many forms of leveraged acquisition, the Target shareholders receive debt obligations of Target in a reverse merger between a dummy subsidiary and Target. In such circumstances, whether or not the debt is convertible or subordinated, it is not caught by Section 279 since it is not issued to acquire stock in "another corporation."

Second, subordination can be effected without coming within Section 279(b)(2) of the Code. Section 279(b)(2) only applies to subordination to creditors of the issuing corporation. One means of providing effective subordination without violating this test is to have the debt in question issued by a holding company (Acquiror in our example) which acquires Target as its wholly owned subsidiary pursuant to a reverse merger of a dummy subsidiary into Target. In these circumstances, creditors of Acquiror can look only to Acquiror's assets -- the stock of Target. Accordingly, they are effectively subordinated to all the debt of Target. This effective subordination is not caught by Section 279(b)(2) of the Code.[46]

Finally, it is easy to avoid Section 279(b)(3) of the Code even though the holder of the debt in question has a substantial equity interest in Acquiror or Target. As

46. See Treas. Reg. § 1.279-3(c); Private Letter Rulings 8337018, 8336009.

noted above, Section 279(b)(3) refers only to debt convertible into stock or issued as part of an investment unit which includes an option to acquire stock. It is commonplace to issue debt as part of an investment unit with common stock of Target or Acquiror. In such circumstances, the debt does not meet the test of Section 279(b)(3). There is an argument, however, that debt issued together with convertible preferred stock may be caught since the convertible preferred stock may amount to an option to acquire common stock.[47]

Criticism of Existing Law

As demonstrated above, existing law offers few impediments to the properly structured highly leveraged acquisition. To the extent that the transaction brings Target's debt-to-equity ratio up to an aggressive but realistic level, there is little cause for concern. For example, if the average debt-to-equity ratio prevailing in the industry in question were 1:1, a leveraged acquisition that brought the ratio up to 2:1 or 3:1 would arguably involve a legitimate business decision, which might not be inconsistent with prevailing

47. Treas. Reg § 1.279-3(d). Note also that when debt is held by stockholders, especially in proportion to their stockholdings, such debt is more likely to be recharacterized as equity under general case law principles. See cases cited in n.42, supra.

practices in privately held companies in the same industry.[48] Where debt-to-equity ratios in manufacturing businesses approach 20:1 or 30:1, however, it is obvious that other factors involved.

This extraordinary leverage realistically implies one or more of the following: (1) equity or risk capital is masquerading as debt to obtain tax deductions for interest; (2) "true" debt is supported by contemplated partial or complete liquidation of Target assets over time; and (3) there is "hidden equity" because the transaction is a bargain purchase. While it is conceivable that the third possibility plays some role in a small minority of cases it is not a realistic explanation in most cases. The leveraged acquisition is generally an arms'-length transaction, and there is no reason to believe that the seller would settle for less than full value. Moreover, SEC rules are designed to assure (and presume the existence of) potential third-party offerors who will "top"

48. Private companies generally tend to be somewhat more highly leveraged than public companies. In part this reflects the perception that markets penalize highly leveraged companies. Much of the disparity, however, is attributable to other factors. For example, the book value of private companies is often highly understated, and there is no trading value for their stock to provide another measure of equity. Moreover, private companies often have "hidden equity" to support their borrowings -- for example, off balance sheet assets and shareholder guarantees. Finally, much of this leverage is shareholder-held debt whose tax status as debt is often questionable.

an inadequate price.[49] The second factor, the prospect of repayment out of liquidation of the business, raises incidental tax issues but clearly involves serious social and economic consequences, which have been the subject of concern in business and government circles. In any event, it is undeniable that a major factor in most very highly leveraged acquisitions is corporate tax minimization.

High leverage should be seen as, effectively, ad hoc unrestrained corporate integration. As such, it is susceptible to grave abuses. In our existing corporate tax system, corporations are taxed on their earnings, and shareholders are subject to a second tax on distribution. Various models of corporate integration have been considered to eliminate this double taxation. These range from a complete integration along partnership or Subchapter S lines, to a deduction for dividends paid or a shareholder credit in respect of corporate taxes. Only the last two are practical in most cases.

Adoption of a credit or dividend model of integration has been considered from time to time in the United States. Both systems have also been employed in various foreign countries. As will be recalled, during the Carter administration, extensive consideration was given to corpo-

49. Lederman, Citron & Macris, supra n.19.

rate integration.[50] Moreover, recent tax reform proposals by the Treasury Department contain a proposal for limited integration through a partial deduction for dividends paid, although the prospects for that change appear dim.[51]

Whenever corporate integration has been contemplated in the United States, it has been considered vital to apply strict limitations on the scope of the concept. For example, integration through a credit mechanism raises the question of whether corporate tax preference items (such as investment tax credit) should in effect be passed through to shareholders. If not, such preferences would lose much of their value. It also involves the need to consider the treatment of tax-exempt domestic and foreign shareholders. Integration through the dividends-paid deduction also raises issues as to scope. For example, under the Treasury Department reform proposals, the

50. See Committee on Corporations of the New York State Bar Association Tax Section, Report on the Integration of Corporate and Individual Income Taxes, 31 Tax Lawyer 37 (1977); see also Gourevitch, Corporate Tax Integration: The European Experience, 31 Tax Lawyer 65 (1977).

51. Treasury Department, Report on Tax Simplification and Reform, 118-19 (November 27, 1984) [hereinafter cited as Treasury Report]; Treasury Deparment, Report on Tax Simplification and Reform: General Explanation of Treasury Department Proposals 132-35 (December 3, 1984) [hereinafter cited as Treasury Proposal]. The Wall Street Journal of March 22, 1985 indicates at page 52 that this proposal will probably be dropped because of its revenue costs. There are also doubts as to whether the interest-indexing provisions of the Treasury's proposal (see Treasury Proposal, supra, at 190-97), which would reduce somewhat the attractiveness of debt financing, will be reflected in any legislation ultimately adopted.

deduction would only be available for half the dividends paid and only to the extent that such dividends were paid from earnings actually subject to corporate tax. Finally, the Reporter's Proposals on the Income Tax Treatment of Corporate Distributions included in the ALI Study suggested a deduction for dividends paid but only in respect of newly invested equity.[52] Thus, deductions would not be available for dividends paid on equity resulting from accumulations of retained earnings; new equity used to displace equity recovered through redemptions; and equity used to effect the acquisition of another corporation. It is quite significant that the Reporter's proposal also eliminated interest deductions on debt issued in those circumstances where an equity issue would not generate dividend deductions -- i.e., debt issued to fund redemptions or to acquire stock of another corporation.[53]

Integration through high leverage is not limited in any of the above fashions. Thus, through high leverage, deductions can be obtained for all (not just half) of what would otherwise be distributions on stock. Such deductions can be layered on top of corporate tax preferences. Moreover, given the general tendency of debt instruments to gravitate to tax-free investors,[54] the elimination of tax in respect

52. ALI Study, supra n.8, at 366-400.

53. Id.

54. This "rate arbitrage" is discussed in the Treasury Proposal, supra n.51 ... at 191, 310. It is also common knowledge that mezzanine "junk bonds" gravitate toward pension plans, IRAs, NOL companies and other effectively tax-exempt investors.

of corporate income paid out as interest will not necessarily be matched by tax to the holder. Finally, except for a system of complete partnership-type integration (which has generally been regarded as impractical for public companies) corporate integration relates only to income distributed as dividends. By contrast, the possibilities for generating interest deductions through the issuance of original issue discount instruments greatly magnifies the benefits and problems in an ad hoc corporate integration through high leverage. As discussed above, original issue discount instruments generate discount deductions which can cover repayment of principal on other debt or other nondeductible expenditures. In this respect, original issue discount debt issued in an acquisition creates the possibility of deducting, on an accrual basis, the expected proceeds of a subsequent corporate liquidation (tax exempt under Section 337) to pay off the discount debt.

All these factors make integration through high leverage more effective in eliminating corporate tax than any realistic express system of integration. This may explain, in part, why business has not come out strongly in support of an express integration scheme. In our current double-tax system, it is difficult for a low-leveraged Target to resist a high-leveraged acquisition. Thus, the tax law is subsidizing high-

leverage acquisitions and is facilitating transactions that expose enterprises to the risks associated with high debt levels.

Proposed Reform

All of these factors point strongly to the need for some reform in this area. The proper response, however, is not entirely clear.

One obvious response would be to reinstate revised Section 385 Regulations dealing with the problem of excessive leverage. The original Section 385 Proposed Regulations, as noted above, did contain a prohibition on excessive leverage. That inclusion, however, generated wide protest generally premised on the assumption that high leverage was present in many real world situations. A broader problem exists in this approach, however. As many authors have noted, the distinction between debt and equity is often only a formal one. A subordinated debenture is, in most respects, equivalent to a preferred stock of comparable terms.[55] By attempting to eliminate excessive leverage by focusing on the debt-equity distinction, much energy will be lost in a definitional quagmire without any necessary increase in certainty. The ex-

55. Taylor, supra n.43, at 853-58.

perience with the Section 385 regulations demonstrates the difficulty in defining debt and equity in all contexts.

A second approach, at the opposite pole, would be to isolate specific types of acquisition transactions and deny interest deductions generated thereby. Section 279, as ultimately adopted, is that type of approach in practice because of its narrow escape. A similar concept was reflected in the proposal of Chairman Mills which predated Section 279 to deny interest deductions on hostile acquisition indebtedness.[56] The latter approach is also being considered by Congress in connection with pending legislation to deny interest deductions for "junior obligations" issued in connection with hostile acquisitions.[57]

There is some merit in attacking particular aspects of the high leveraged phenomenon. As previously noted, the hostile junk bond acquisition raises serious tax as well as social and economic concerns. In effect, through the mechanic of the two-tiered offer, this form of transaction can be used to force the liquidation of an otherwise viable business concern. Also, the hostile junk-bond offering involves fewer

56. H.R. 7489, 91st Cong., 1st Sess., 115 Cong. Rec. 4210 (1969).

57. H.R. 1100, 99th Cong., 1st Sess. (introduced February 19, 1985).

protections for the shareholder than a negotiated transaction and, therefore, increases the possibility that junior subordinated debt involving down-side equity-type risks will be issued to public shareholders in a "cram-down" merger. Very few spokesmen will be heard to speak in favor of this particular form of acquisition. Accordingly, denying interest deductions or debt issued in connection with such acquisitions is probably not a bad idea. It does not, however, attack in full the problem of excessively leveraged acquisitions and should not be considered a complete solution to the problem.

An appropriate method of attacking the problem of excessive leverage in corporate acquisitions is to deal with it directly. A statutory section along the lines of Section 279 could be drafted which simply denied interest deductions in respect of corporate acquisitions (i.e., the acquisition of a controlling interest in a corporation by purchase or redemption) involving leverage in excess of defined levels. (The recharacterized interest could be treated as dividends, which is not true of existing Section 279.) The question of defining excessive leverage is a mechanical one for which there are a number of possible solutions. The measure of leverage which is easiest to apply, however, would refer to prevailing debt-equity ratios in the business sector in

question.[58] Thus, one possibility would be to authorize the Secretary of the Treasury to classify industries according to some widely understood and available index such as that contained in the Standard Industrial Classification Manual, Moodys, stock exchange classification, etc. It would be desirable to select an index which took into account, to some degree, privately held as well as public companies. The Secretary could derive debt-to-equity ratios which represent weighted averages for the companies in each such sector. The statutory provision could provide that acquisitions generating debt-to-equity ratios more than a certain percentage of the weighted average debt-to-equity ratio for the sector in question would be considered excessively leveraged. The test would be applied at the time of issuance except, possibly, that increases in leverage resulting from expected accruals on original issue discount debt might be taken into account.

For example, if the weighted average debt-to-equity ratio for companies in the petroleum products business was, say, 1.5:1, a leveraged acquisition would be considered to create excessive debt if it resulted in a debt-to-equity ratio of, say, 4.5:1 or greater. Obviously, fixing the per-

58. An alternative approach might be to look to expected debt-service coverages. However, that would make the tax law result dependent on projections of the outcome of a particular transaction, which would often be speculative and subject to manipulation.

centage to be applied to the prevailing debt-equity ratio would involve sensitive and important policy issues. In order not to interfere with transactions not involving abuses, it might also be advisable to provide a "floor" debt-to-equity ratio such as 3:1 in the statute or regulation so as to permit entities to leverage-up to that level without regard to prevailing industry patterns.

Many provisions of Section 279 and the Regulations thereunder dealing with the debt-equity ratio could be adapted to the new provision. For example, the debt-equity ratio should be determined on an affiliated group basis, following Section 279(g) and Regulations § 1.279-6. Special provision should be made for businesses such as banks and financial institutions where assets are matched to liabilities. Matched assets and liabilities should not enter into the debt-to-equity ratio except to a very limited extent. That result can be achieved by looking to prevailing debt-to-equity ratios in the financial business sector in question or by eliminating matched assets and liabilities from the equation.[59] Similarly, non-recourse liabilities,

59. Section 279(c)(5) of the Code contains a special rule for banks and financial institutions as did the various versions of the Section 385 Regulations. Proposed Reg. § 1.385-3(c)(5)(iii), 45 Fed. Reg. 18957, 18965 (March 24, 1980); Final Reg. § 1.385-6(g)(5)(iii), 45 Fed. Reg. 86438, 86454 (December 31, 1980).

as well as assets equal thereto, might be excluded from the computation. Finally, since the new provision would be limited to acquisition indebtedness (but including "redemption" debt of Target) the choice between using book value or fair market value in determining Target's debt-equity ratio is not likely to be critical since GAAP purchase accounting would tend to equate the two.[60]

Once the debt-to-equity ratio threshhold was exceeded, the question would arise of determining which debt should be deemed to generate nonallowable interest deductions. There are several possible approaches to this problem. One sensible approach would be to disallow interest deductions on classes of indebtedness which are more "suspect" of being equity in character than others. For example, the first deductions disallowed could be those in respect of debt held proportionately with equity. The second disallowed class could be debt which participates substantially in earnings. The next disqualified class could be debt which is subordinated either by express subordination or by virtue of its having been issued by a holding company whose major asset is Target. The next order of priority might be classes of debt which bore Moodys or Standard & Poor ratings substan-

60. Committee on Accounting Procedure of the Accounting Principles Board, Opinion No. 16 (issued August, 1980).

tially lower than that of other debt of Target or Acquiror.[61] Finally, to the extent leverage remained excessive, interest on a proportionate part of the remaining debt could be disallowed.[62] In most cases, this last category will not be reached since the capitalization of the junior debt classes will usually generate a satisfactory debt-equity ratio.

The application of this proposed statutory solution to a real world problem can be demonstrated by referring back to our earlier example. As discussed on page 22 above, that example assumed a company with equity initially worth $100 million, which generated a 20% pre-tax return. If we assume that the average debt-to-equity ratio in the industry in question was 0.5:1 (somewhat higher than the actual average for the petroleum industry), the proposed statute would deem leverage excessive if the acquisition resulted in a debt-to-equity ratio in excess of say, 1.5:1. Accordingly, in the two highly leveraged models discussed above involving the issuance of interest-paying or original issue discount debt, the result would be to disallow interest deductions with respect to $30 million of the subordinated debt with the following pattern of income, tax, and growth of equity:

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61. This last category is reflected in H.R. 1100, supra n.57.

62. See generally, Plumb, The Federal Income Tax Significance of corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369, 629-32.

Transaction 1

Under the Proposal

Year	Income Before Interest Expense	Tax	Debt Service	Residual Common Equity
1	21,000,000	6,600,000	12,600,000	101,800,000
2	21,378,000	6,789,000	"	103,784,000
3	21,795,690	6,997,845	"	105,986,845
4	22,257,237	7,228,619	"	108,415,464
5	22,767,247	7,483,624	"	111,099,087
6	23,220,808	7,765,404	"	114,064,492
7	23,053,543	8,076,772	"	117,341,263
8	24,641,665	8,420,833	"	120,962,096
9	25,402,040	8,801,020	"	124,963,116
10	26,242,254	9,221,127	57,000,000	84,384,243
11	17,720,691	7,660,346	7,200,000	87,244,588
12	181,321,364	7,960,682	"	90,405,270
13	18,985,107	8,292,553	"	93,897,824
14	19,718,543	8,659,271	"	97,757,095
15	20,528,990	9,064,495	"	102,021,590
15	21,424,534	9,512,267	"	106,733,857
17	22,414,110	10,007,055	"	111,940,912
18	23,507,592	10,553,796	"	117,694,708
19	24,715,889	11,157,944	"	124,052,652
20	26,051,057	11,825,528	52,200,000	86,078,181

Transaction 3

Under the Proposal

Year	Income Before Interest Expense	Tax	Debt Service	Residual Common Equity
1	21,000,000	6,552,000	5,400,000	109,048,000
2	22,900,080	7,294,373	"	119,253,707
3	25,043,279	8,123,749	"	130,773,237
4	27,462,380	9,050,771	"	143,784,846
5	30,194,818	10,087,448	"	158,492,216
6	33,283,365	11,247,344	"	175,128,237
7	36,776,930	12,545,789	"	193,959,378
8	40,731,469	14,000,117	"	215,290,730
9	45,211,053	15,629,950	"	239,471,834
10	50,289,085	17,457,511	49,400,000	221,903,408
11	46,599,716	17,482,983	0	251,020,140
12	52,714,230	19,572,313	"	284,162,057
13	59,674,032	21,923,223	"	321,912,867
14	67,601,702	24,570,216	"	364,944,353
15	76,638,314	27,552,528	"	414,030,139
16	86,946,329	30,914,969	"	470,061,500
17	98,712,915	34,708,577	"	534,065,837
18	112,153,826	38,991,626	"	607,228,036
19	127,517,888	43,830,665	"	690,915,259
20	145,092,204	49,301,758	977,603,467	(190,897,762)

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The net result of this disallowance would be to leave residual equity at $86,078,181 in Transaction 1 and $(190,897,762) in Transaction 3.

The proposed statutory reform along the lines outlined above does involve some complexity. Most of the burden of complexity, however, would be borne by the Treasury, which would have to come up with relevant debt-to-equity ratios. In practice, the law would be much simpler to apply than the existing debt-equity or Section 279 morass. More importantly, the proposed change would go far to eliminating the severe encroachments on the corporate income tax engendered by ad hoc corporate integration through excessive leverage.

There is precedent in Section 279 of the Code for dealing with acquisitions as a special case. By focussing on acquisition transactions, the proposal would deal with the most critical problem -- the effective tax exclusion of an existing stream of corporate income. If this change is adopted, consideration could then be given to the more complex question of debt-equity and excessive leverage outside the context of corporate acquisitions.

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May 10, 1985

E. William Cole
Vice President
Washington Office

Donald W. Riegle, Jr.
United States Senate
Committee on Banking, Housing
and Urban Affairs
Washington, D.C. 20510

Dear Senator Riegle:

Unocal testified at the hearing on April 3, 1985 before the Committee on Banking, Housing, and Urban Affairs which was called to examine whether the recent increase in corporate mergers is in the best interest of American industry. You were not able to ask all your questions in the allotted time and, therefore, requested witnesses to respond to certain additional written questions. By letter dated April 17, 1985, we were asked to answer the following question for the record:

Senator Riegle:

> Is our tax system neutral with respect to hostile takeovers, leveraged buyouts and break-up liquidations or does it in fact encourage or discourage that activity?

Introduction

Speaking from the experience of a company that is in the midst of defending itself from a hostile takeover attempt by Mesa Petroleum Co. ("Mesa"), Unocal believes that the tax system encourages hostile takeover activity and that corrective legislation is necessary.

The clearest example of the subsidization of hostile merger activity is the deductibility of interest on both the bank loans and junk bonds that finance such activity. Tax assistance such as the deductibility of interest as an expense is warranted to build the economy but is indefensible in connection with hostile takeovers which have such a destructive effect on our economy.

There has already been much debate on the impact of the interest deduction on hostile mergers. However, there are other more subtle and technical tax gimmicks that have not been adequately scrutinized. Utilizing these gimmicks, raiders may claim capital gains on sales that should be taxed as ordinary income, use the installment sale method to obtain an interest free loan from the government on transactions that should be immediately taxable and deduct expenses that should be capitalized.

Because of the Mesa raid against Unocal, we have examined previous Mesa transactions in an attempt to discover how the tax laws may have facilitated those transactions. As a case in point, we have reviewed Mesa's attempted takeover of Gulf in 1983 and its sale of Gulf stock in 1984 at a reported profit of over $400 million.

It is not known whether Mesa has filed its return for 1984 in connection with the Gulf transaction or, if so, what position it has taken on its return. However, the issues are significant enough to require intense IRS examination when Mesa returns are audited (IRS has not yet examined Mesa's returns for years after 1980) and may require corrective tax legislation to prevent manipulation and abuse by corporate raiders in the future.

The Gulf Transaction

During August through September, 1983 Mesa acquired an aggregate of 8,200,000 shares of Gulf common stock in transactions on national stock exchanges.[1/] On September 30, 1983,

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1/ This description of the transaction is based primarily on Schedules 13D dated October 5, 1983 and June 13, 1984 (Amendment No. 38) filed with respect to Gulf by various Mesa companies and on Schedule 14D-1 filed by SoCal on March 7, 1984 and Schedule 13D (Amendment No. 3) dated June 15, 1984 and filed by SoCal with respect to Gulf.

Mesa transferred such shares to Mesa Asset Co., a wholly-owned subsidiary of Mesa, which was incorporated on September 26, 1983. On October 5, 1983, Mesa Asset sold a portion of its Gulf shares to other entities in the investor group and between October 5 and October 14, 1983 the investor group, including Mesa Asset, acquired additional Gulf shares. On October 14, 1983, Mesa Asset transferred its remaining Gulf shares to Mesa Offshore Co., a wholly-owned subsidiary of Mesa, which was incorporated on January 3, 1972. Mesa Offshore was a shell corporation whose only assets consisted of the Gulf shares and $1,000 of cash or cash equivalents.

On February 23, 1984, Mesa and other members of its investor's group commenced a tender offer for up to 13,500,000 shares of Gulf at $65 per share. On February 24, 1984 the Gulf Board of Directors determined that the offer was unfair and inadequate and recommended that the Gulf stockholders reject the Mesa offer.

Thereafter, Gulf began looking for a white knight to save it from the Mesa offer. Standard Oil of California ("SoCal") won the bidding for Gulf with a tender offer on March 7, 1984 to acquire all the outstanding shares of Gulf for $80 a share. The tender offer was made pursuant to a merger agreement dated as of March 5, 1984 among SoCal, a SoCal

subsidiary and Gulf. The merger agreement provided that the SoCal subsidiary would be merged with Gulf and each outstanding share, other than shares held by SoCal and by stockholders exercising appraisal rights, would be converted into a right to receive $80 in cash. The merger was effected on June 15, 1984.

Immediately before the SoCal/Gulf merger, Mesa, on June 13, 1984, sold all of the shares of Mesa Offshore (which then owned 14,467,458 Gulf shares) to a wholly-owned subsidiary of Penn Central for $1.1 billion. Penn Central had provided financial backing for Mesa's attempt to take over Gulf. Although the transaction was structured as a sale of Mesa Offshore stock, the stock purchase agreement contemplated that Penn Central might file a "section 338 election." That election would allow Penn Central to treat the transaction as if it purchased the assets of Mesa Offshore (i.e., the Gulf shares) so that it could obtain a step-up in basis for the acquired Gulf shares equal to the price paid for the Mesa Offshore stock.

The consideration paid by Penn Central consisted of Penn Central's return of subordinated notes, preferred stock and warrants that had been issued by Mesa to Penn Central for $300 million in February 1984, $12 million in cash and a five-year installment note in the principal amount of $796 million.

Mesa's 1984 Annual Report states that the sale resulted in approximately $404 million of pretax gain to Mesa. 2/

The stock purchase agreement dated June 13, 1984 among Mesa, Penn Central and the Penn Central subsidiary contemplated that the Gulf shares owned by Mesa Offshore would be sold by Penn Central pursuant to the SoCal/Gulf merger agreement. On June 21, 1984 (just eight days after its purchase of Mesa Offshore) the Penn Central subsidiary sold the Gulf shares held by Mesa Offshore to SoCal for approximately $1.16 billion in cash. 3/

The Mesa sale to Penn Central appears to have been arranged with a careful eye to the tax laws and raises a number of questions as to how the tax laws should be interpreted.

Capital Gains

As one commentator noted in a recent article, corporate raiders often claim preferential long-term capital gains treatment for their raiding gains.

2/ Mesa Petroleum, Annual Report 1984, p. 27.

3/ The Penn Central Corporation, 1984 Annual Report, p. 44.

> Long-term capital gains treatment may be claimed even if the hostile bidder has not held the stock for more than the six-month holding period. For example, a hostile bidder having a shell subsidiary corporation that is more than six months old could have that subsidiary purchase the target's stock with new money contributed to the subsidiary. The hostile bidder could then sell the subsidiary's stock to the target company in exchange for the greenmail payment, and take a long-term capital gain on the sale of the subsidiary's stock.4/

According to contemporaneous newspaper accounts, Mesa used its shell corporation, Mesa Offshore, in an attempt to turn short-term capital gain into long-term capital gain. The New York Times reported one analyst's conclusion that Mesa would pay $130 million less in taxes because the transaction was structured to obtain long-term capital gains treatment.5/

It appears questionable whether the sale of Gulf stock would qualify for long-term capital gains treatment at a 28 percent rate (as opposed to short-term gains treatment or ordinary income treatment at the top corporate rate of 46 percent).

4/ Jonathan Barry Forman, "Using the Tax Code to Fend Off Corporate Takeover 'Sharks,'" Tax Notes 1162, 1164 (March 18, 1985).

5/ The New York Times, June 6, 1984, p. D5.

First, assuming the Gulf shares were contributed to Mesa Offshore in a tax-free exchange, the Mesa Offshore shares arguably would have the same holding period as the Gulf stock contributed to Mesa Offshore.[6/] Since the Gulf stock was not held for the long-term capital gains holding period of one year, the Mesa Offshore stock also would be deemed not to have been held for the one-year period.[7/]

Second, the Internal Revenue Service could assert that the substance of the transaction was really Mesa's sale of Gulf stock, rather than the sale of stock of its shell subsidiary. Under this theory, long-term capital gains treatment also would not be available since the Gulf stock was not held for the one-year holding period.

Third, if the transaction is treated as the sale of Mesa Offshore stock, the Service could take the position that Mesa Offshore is a collapsible corporation so that the entire gain is ordinary income under IRC § 341. Generally, for § 341 to apply, the Gulf stock would have to be held by Mesa Offshore as stock in trade or property held by the corporation primarily

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6/ IRC § 1223(1).

7/ The change to a six-month holding period for long-term capital gains is effective only for property acquired after June 22, 1984.

for sale to customers in the ordinary course of its trade or business, i.e. not as a capital asset. At least one commentator has concluded that if the hostile bidder is in the business of corporate raiding, the target's stock should not be treated as a capital asset in the hostile bidder's hands under the rule in Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).

> For example, a developer in the business of buying and selling parcels of land will have ordinary income, not capital income, upon the sale of a parcel of land. The same tax treatment should apply to someone in the business of purchasing and threatening to purchase corporations. Query. How many times does an investor have to receive greenmail before it is appropriate to conclude that the investor is in the business of greenmailing?8/

In this case, Mesa's acquisition history over the last few years raises a substantial question as to whether it is in the business of corporate raiding and thus whether it holds the stock of its targets as a capital asset or as property for the sale to customers in the ordinary course of its trade or business.9/

8/ Forman, supra at note 4.

9/ Since 1981 Mesa and its affiliated companies and associates have been involved in purchases and sales of stock of a number of oil companies, including Cities Service, Supe-

[Footnote continued next page]

Installment Sale

Because Mesa received a five-year note in the principal amount of $796 million in partial payment for the stock of Mesa Offshore, it reported gain on the transaction under the installment method. Mesa's 1984 Annual Report shows almost $145 million as deferred U.S. income tax on gain on installment sale of securities and assets (all or a major portion of which appears to relate to the sale of Mesa Offshore).10/ The Annual Report further states that following the sale of Mesa Offshore, Mesa entered into a new term loan agreement with banks which provided for borrowings of $785 million. Such borrowings were secured by a pledge of the $796 million Penn Central note. In essence, Mesa deferred a substantial portion of its gain on the sale of Mesa Offshore for a period of five years, while

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[Footnote continued from preceding page]

rior, GAO, Gulf, Phillips, KN Energy, Supron Energy, and Unocal. Mesa's 1984 Annual Report shows that during the period 1982, 1983 and 1984 the company purchased securities of over $1.4 billion (compared to net oil and gas capital expenditures of less than $660 million). During this same period, Mesa had pretax gain on the sale of securities of over $530 million including a 1984 gain of $404 million on Gulf stock, a 1983 gain of $31.6 million on Superior Oil and $33.2 million on GAO and a 1982 gain of $22.3 million on Supron Energy, $31.5 million on Cities Service and $10.4 million on GAO. In addition, Mesa has a 1985 gain of $80 million on the sale of Phillips stock. Mesa Petroleum, Annual Report 1984, p. 42.

10/ Mesa Petroleum Co., Annual Report 1984, p. 44.

immediately receiving the cash equivalent of almost 99 percent of the principal amount of the note. Under some circumstances, the use of an installment note as collateral will be treated as a disposition of the installment note, thus triggering the recognition of any deferred gain.[11/] However, the Treasury itself has recognized that "if a taxpayer pledges an installment obligation as collateral for a loan, he may, under some circumstances, continue to defer his tax on the sale."[12/] In effect, under the installment method, the federal government makes an interest-free loan to the taxpayer of the tax that otherwise would be due in the year of sale. Treasury recognizes that the benefit of tax deferral is not appropriate where the taxpayer has obtained cash by pledging an installment obligation. To eliminate this abuse, Treasury proposes that on or after January 1, 1986, any amount borrowed that is secured by an installment obligation would be treated as a payment on the installment note.

This legislative change is long overdue. But there are other aspects of Mesa's use of the installment sale that the Internal Revenue Service might well question under existing

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11/ See, e.g., Rev. Rul. 65-185, 1965-2 C.B. 153.

12/ 2 Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth, 212 (Nov. 1984).

law. Why did Mesa sell the Mesa Offshore shares to a subsidiary of Penn Central which then sold the Gulf shares when the Gulf shares could have been sold directly to SoCal pursuant to the SoCal tender offer? If Mesa had sold the Gulf shares to SoCal for cash, the gain would have been immediately taxable. By selling the Mesa Offshore stock to the Penn Central subsidiary for consideration which included a note, it was able to defer a significant portion of federal income taxes. This tax avoidance purpose was, in effect, acknowledged by Mesa's Chairman T. Boone Pickens, Jr. who "said in an interview that the deal with Penn Central would allow Mesa to defer some of the income from its Gulf holdings by channeling it into the Penn Central note."[13/] Moreover, the transaction was essentially riskless to Mesa because Penn Central's payment of the note was secured by bank letters of credit which in turn were backed by Penn Central's pledge of approximately $796 million of cash received from its sale of Gulf stock to SoCal.[14/]

13/ The Washington Post, June 6, 1984, p. D9.

14/ The Penn Central Corporation, 1984 Annual Report, p. 44. Penn Central's issuance of an installment note backed by a standby letter of credit which in turn was backed by Penn Central's cash deposits raises the question of whether such an arrangement should be treated as a payment subject to immediate tax rather than qualifying for installment sales treatment. IRC § 453(f)(3), amended by the Installment Sales Revision Act, provides that third party guarantees used as security for a deferred payment should not be treated as a payment received on

[Footnote continued next page]

It would appear that the sale to the Penn Central subsidiary could be challenged as a sham transaction designed principally for the tax avoidance purpose of permitting Mesa to defer gain under the installment method, rather than being taxed immediately on the full gain if the shares had been sold to SoCal for cash.[15/] It could be argued that Penn Central, in effect, acted as the agent for Mesa in selling the Gulf stock to SoCal. If the use of an intermediary to permit the seller to obtain installment sale treatment in a transaction that would not otherwise qualify for such treatment is permissible under present law, a legislative change is in order to preclude that type of abuse.

[Footnote continued from preceding page]

an installment note. Temporary regulations provide that a standby letter of credit even if backed by additional cash collateral is not treated as a payment, but that the deposit of cash in an escrow account which the payee may look to directly in the event of default is treated as a payment. Compare Examples 7 and 8 of Reg. § 15a.453-1(b)(5). A standby letter of credit backed by cash deposits is an indirect escrow arrangement that is the equivalent of a payment. Accordingly, the temporary regulations should be amended to so provide. In the absence of an administrative change, Congress should consider a legislative clarification of this point. Installment sales treatment should not be available in such a situation.

15/ See, e.g., Rev. Rul. 74-87, 1974-1 C.B. 72. See also Ruddick Corp., 83-2 USTC ¶ 9480 (U.S. Cl. Ct. 1983).

Expenses of Raiding

In the course of a hostile takeover bid, significant expenses are incurred including commitment fees in connection with financing the hostile takeover and the fees of lawyers, accountants and other advisors.16/ There is a possibility that such expenses might be claimed as ordinary and necessary business expenses. Since these expenses were incurred in connection with the acquisition of stock, the more appropriate treatment might be to capitalize these expenses as part of the cost of acquiring the Gulf shares. Such expenses thus would reduce the amount of any gain being claimed as long-term capital gain, rather than being treated as an ordinary deduction. This is another area in which a legislative clarification would be appropriate.

Conclusion

Mesa's tax treatment of the Gulf transaction has a special importance since Mesa did not pay any federal corporate income tax during the ten-year period 1973 to 1983. Mesa's use of some of the techniques discussed above may have contributed to that result. The tax laws even when properly interpreted

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16/ For example, pursuant to a December 1984 agreement with Phillips, Mesa will sell back its shares of Phillips stock and be reimbursed for actual expenses up to a maximum of $25 million. Mesa Petroleum Co., Annual Report 1984, p. 42.

provide tax incentives for hostile takeovers that Congress should reconsider, particularly the ability to pledge an installment note in a cash borrowing. Quite apart from legislative change, the Internal Revenue Service has the obligation under existing law to closely examine the tax treatment of the fruits of hostile takeover activity to ensure that there are no raids on the Treasury.

Sincerely,

E. William Cole
Vice President

Senator D'AMATO. Senator Metzenbaum.

Senator METZENBAUM. I just have one question and that is, when you're selling junk bonds it's my understanding that many of those bonds are going to banking houses and savings and loans.

I would like you, Mr. Lipton, or anyone else to respond as to how much the Federal Government is involved in underwriting or at least being partially responsible for those junk bonds inasmuch as we know of the Continental Illinois deal of $7.5 billion that the Federal Government at least offered to put up, what we know about the FDIC and the FSLIC. Is there any exposure to the Federal Government in connection with the possibility of defaults with respect to junk bonds or is that not a problem?

Mr. LIPTON. I don't know the answer to that question, Senator.

Mr. MONTGOMERY. Yes; there is a Federal exposure because obviously those federally insured savings and loans, the depositors, do have the insurance that protects their deposits if the management has invested the funds indirectly and perhaps some attention needs to be given to the powers that S&L's have, particularly federally insured ones, as to investments they make other than in their traditional mortgage area.

Senator METZENBAUM. Mr. Chairman, in that connection——

Senator D'AMATO. There is an exposure and it's a question we're looking into with respect to FSLIC and maybe tomorrow when some of the regulators come in we may be able to pose that question to the panel, but it is one that I have had an opportunity to discuss with the Chairman and it's one in which a number of institutions in California—to date they have not had a bad experience. As a matter of fact, these institutions have shown a great degree of profitability. However, the question is, will you get someone who invests in some of those junk bonds to face reality with respect to the name given to the bonds? There are many who will suggest that the term "junk" should not be applied to the quality of some of these bonds and I think it's a very fair argument.

Senator METZENBAUM. Mr. Chairman, it's unfair, in my opinion, that the Federal Government has got an exposure out there with respect to savings and loans as well as possibly some banks because we stand behind FSLIC and FDIC and I think the States have lowered their requirements and they permitted many of these institutions to truly wheel and deal and go into venture capital deals and out of the kinds of areas they were in the past.

Senator D'AMATO. I call to my good friend, Senator Metzenbaum's attention that tomorrow Preston Martin, Vice Chairman of the Federal Reserve, will be one of the panelists and I think appropriately the nature of those questions with the Reserve Board people would be an area that we should raise that question with and be a little more specific with.

Senator METZENBAUM. Well, I'm going to try to be here if I don't have a conflict.

Senator D'AMATO. I'll be happy to offer any questions you might have. We will convene tomorrow morning at 9:30. I don't mean to cut the Senator off.

Senator METZENBAUM. You're not cutting me off. I'm through.

Senator D'AMATO. OK. Let me thank the panelists for coming in today. I think we have been able to focus on some of the differing points of view. We will have another hearing tomorrow and probably 3 days more when we come back from recess. I think there will probably be some legislation that will flow. I thank you for your cooperation, for your participation and your suggestions.

We stand in recess until tomorrow morning at 9:30.

[Whereupon, at 12:25 p.m., the hearing was recessed, to be reconvened Thursday, April 4, 1985, at 9:30 a.m.]

IMPACT OF CORPORATE TAKEOVERS

THURSDAY, APRIL 4, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met, at 9:40 a.m., in room SD-538, Dirksen Senate Office Building, Senator D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Hecht, Cranston, Sasser, and Proxmire.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The committee will come to order.

This is the second day of hearings on the issue of corporate takeovers including the problems of greenmail and two-tier tender offers.

Today we're listening to the regulators. When Congress reconvenes, we will set a schedule—that will probably encompass an additional 3 days of hearings.

I'm mindful of the pressure that is being brought and much of the concern, both within the Congress and outside of the Congress, as to the issues that we're confronted with. However, the one thing that we don't want is a legislative initiative without everyone being given an ample opportunity to make known their views and without this committee having an opportunity to participate fully and have a balanced record—before we undertake legislative initiatives.

It's too easy to just say, well, yes, there's a problem and then rush in and maybe what appears to be the answer, in fact creates more problems. I'm not precluding legislative initiatives, I'm just saying I hope that we could be active as a committee in unison and if necessary attempt to hammer out a bill that would make sense.

Our first witness today—and I want to thank him for being here—is John Shad, Chairman of the Securities and Exchange Commission

Chairman Shad, we're delighted to have you with us and look forward to your testimony and to your answers to some of our questions.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. SHAD. Thank you very much, Chairman D'Amato and Senator Proxmire and other members of the subcommittee.

It is requested that the written statement previously provided be included in the record, in the absence of objection.

Senator D'AMATO. Without objection, your entire testimony will be accepted into the record.

Mr. SHAD. Thank you.

The Commission has not as yet addressed some of the newly emerging tender offer issues, but I appreciate this opportunity to testify today. I would like to applaud Chairman D'Amato for the decision to hold these timely hearings.

SIGNIFICANT CHANGES IN THE MARKETPLACE

Since last year, significant changes in the marketplace, tender offer practices, judicial decisions, and State and Federal legislation, have mooted some issues and raised new ones. For example, in the greenmail area, companies that have purchased shares at a premium from one potential bidder have often found that they were subject to similar greenmail transactions or threats from others. Some companies are adopting charter provisions that prohibit or limit their ability to repurchase from greenmailers. They're giving public notice that they will not buy off potential bidders.

The Deficit Reduction Act passed last July may also dampen greenmail and other practices. It reduces the 85-percent corporate dividend exclusion for tax purposes to the extent that borrowed funds are used to acquire shares. This will make it more expensive to finance some of these transactions. The Deficit Reduction Act also addresses golden parachutes by imposing a 20-percent excise tax on the recipient and eliminating the corporate deduction for tax purposes. And it gives added incentives to employee stock purchase plans by permitting lenders to ESOP's to exclude, for tax purposes, 50 percent of the interest received on such loans.

In the State law area—in January, the Delaware Chancery Court upheld the adoption of a poison pill plan by Household International's directors. The case is on appeal and the SEC has filed an amicus brief urging that the decision be reversed.

There are a variety of poison pills. The most virulent today are warrants distributed at the board's discretion as dividends to a target company's shareholders. In the event of a hostile takeover, the warrant holders have the right to purchase a large number of the bidder's shares—not the target's, but the bidder's shares—at a deep discount from the market price. It is a powerful defensive tactic that can be implemented solely by the target's board of directors. The shareholders are totally removed from the decision process.

Some contend that in response to the threat of hostile tender offers, shareholders are being disenfranchised through corporate recapitalizations, charter and bylaw amendments, State statutes, so-called poison pills, and other corporate defensive tactics which inhibit or prevent takeovers.

Some corporations are recapitalizing into two classes of stock, with one class having little or no voting rights. Others are amending their charter and bylaws to require that changes in corporate control be subject to approval by the holders of up to 80 percent of the shares, and that the highest price paid for any of the shares must be paid for all of the shares.

In 1983, 2 years ago, over 200 corporations adopted such provisions. Over 400 corporations did so last year, and over 500 companies are expected to do so this year.

Also 10 States have recently enacted statutes, the effects of which are also to permit the holders of a small portion of the shares to prevent changes in corporate control.

Senator D'AMATO. Mr. Chairman, if I might—and I know this is a little unusual but—I'd like to ask a question just on that point because we discussed this yesterday.

We talk about one share, one vote. People see that as a principle of government and democracy. What about in the area of corporate governance. Does it concern you that we see these kinds of defenses being raised—in my opinion at least—there is a tremendous element of unfairness, when shareholders are disenfranchised by the issuance of a new class of stock with up to 10 votes for every share.

Mr. SHAD. Very definitely. I think it's a very serious issue. I'd like to briefly provide some of the rationale or arguments that are advanced in support and in justification, not the least of which is that the shareholders approve these recapitalizations.

But I would like to highlight some of the arguments on both sides of these key issues. I agree completely, and it does trouble me considerably.

Senator D'AMATO. And I'd like you, if you would, to address yourself as to what action, if any, we should take? There was a suggestion that one of the exchanges was to blame, the New York Stock Exchange. I think that is absolutely not the case, that's fallacious. I also understand that the American Stock Exchange has indicated that they would be willing to adopt a rule prohibiting disproportionate voting rights if the NASD would do the same.

I don't know what the chances are, but a question I'd like you to think about as you continue, is should there be any legislative initiative in this area?

Mr. SHAD. Well, as I just mentioned, the proponents of such recapitalization charter and bylaw amendments contend that the increasing institutionalization of the securities markets and the rising threat of hostile tender offers is causing corporations to defer research and development on other projects which are in the short- and long-term best interest, not only of shareholders, but of the Nation as a whole.

R&D IS ON THE RISE

Surveys of several hundred companies by the SEC's Office of the Chief Economist do not support this conclusion. They reviewed several hundred companies, and they find that during the past 4 years of rising interest in these companies by institutions, their R&D is also going up as a percentage of sales and they've done much more. I was looking at the latest study last night; and, if of interest, I'd

like to ask Dr. Lehr, who prepared these studies, to amplify this point.

This is a sea of rhetoric and to get hard facts in terms of what is happening out there, and what the companies are doing, is very difficult. We have, as I just mentioned, been trying to ventilate both sides of the issue.

We had a recent economic forum to which we invited the top economists from academia, from industry, and our own people, to have a free-for-all, and there were few hard numbers to look at, even with that group, who are primarily numbers oriented. And we've been trying to develop more empirical evidence on the issue.

On this latest one, our conclusion is that it's not supported by the best evidence that we've been able to develop.

Proponents of these recapitalizations and other defensive tactics, go on to point out that recapitalizations, charter and bylaw amendments, and so forth, are subject to approval by the shareholders under State law, and that they permit corporate executives to manage companies in the best interest of all their shareholders as well as their employees, customers, suppliers, and communities.

Others contend—and I think this is maybe the most important statement I'm going to make today—others contend that if these trends are permitted to persist, a significant segment of the investing public will have little or no voting rights and, therefore, no bargaining position in a keenly competitive economic environment in which all others, management, employees, customers and suppliers, have significant bargaining positions.

Still others point to the rising opposition to such defensive tactics by institutional investors, particularly the powerful State pension funds, the 22-member Council of Institutional Shareholders with over $100 billion, and many others. Those who note the rising opposition from institutions also express greater confidence in the marketplace than they do in State and Federal regulation to respond to these complex, rapidly evolving, transient issues. Some say that we regulators—and even some legislators—as old generals, are fighting the last war; and by the time we get there the marketplace is so sensitive, so creative, so innovative and entrepreneurial, that it's going on beyond it. And when we erect barriers, why, the market seems to find a way to go under, over, and around the barriers.

Senator D'AMATO. Chairman Shad, I can't help but wonder, was that not the attitude expressed in the late 1920's—let the marketplace do it all. When we had a situation where people were buying fortunes of stock leveraged beyond the point that we now say is reasonable.

So when I hear—and I certainly consider myself to be a market-oriented person—when I hear "let the market determine" and "how wise people are", I also say, you've got to balance that with the fact that people chase the easy dollar as evidenced by the collapses that we have seen recently that have imperiled some our financial markets. I'm not going to take this hearing into another area, we'll come into that with regard to Government securities at another time—but I am wondering, how you view that?

Mr. SHAD. Let me conclude my prepared remarks with a last thought. Other than the Delaware amicus brief, and my recent letter to you, Senator D'Amato, which is an exhibit to our promo

statement, in response to some alternative approaches—the Commission has not as yet addressed these emerging multifaceted issues.

Senator PROXMIRE. Chairman Shad, will you pull the microphone a little closer; it's a little hard to hear.

Mr. SHAD. Yes, sir, I'm sorry.

I'll also speak up, Senator. I appreciate it because I don't always hear what people are saying—as well as I should. [Laughter.]

Senator D'AMATO. That's what my Momma used to tell me. She said, "Alfonse, you only hear the things, I think, you want to hear." [Laughter.]

Senator PROXMIRE. Alfonse, that's why you look so healthy. [Laughter.]

Mr. SHAD. Anyway, we haven't reached any conclusions on a lot of these issues. We are looking forward to the results of these hearings. We again applaud Chairman D'Amato for calling them because the issues are arising so rapidly and new legislation is being proposed both by Members of Congress and by very able members of the private sector, that we haven't had the time or the opportunity as yet to really put it all down and try to do some comparative analyses of how the pieces fall together.

I can express a personal preference, and it tees up the area that you were just addressing, Senator D'Amato: and that is that you get reactions and interreactions back and forth in this enormous, giant mobile that is our economy of so many different factions.

It's all interrelated; and, as the different defenses and aggressions take place, there tends to be an interrelated—correlated almost—reaction. And I'm not sure that there's any mind or system that can adequately correlate these multiple variables and do it fast enough to be effective.

CONFIDENCE IN THE MARKET DISCIPLINES

So I identify myself with those that do have greater confidence in the marketplace—the disciplines of the marketplace—than in regulatory or legislative processes at the present time.

Now, I certainly do agree that there have been some egregious, outrageous failures—but I must hasten to add they've not been due to the structure of the system so much as they have been due to outright fraud. In fact, massive collusion, in my opinion. I testified yesterday on one of these, and I think that that's not what we're addressing here. I think that we're not addressing fraudulent activity but rather how the game is to be played, how the players are to be regulated.

And so, as I say, I would cast my lot with those who put greater confidence in the flexibility of the marketplace to rapidly respond rather than in more rigid approaches.

Senator D'AMATO. Mr. Chairman, let us revisit the issue of greenmail.

Do you think that permitting greenmail is a good policy, or should we undertake some legislative initiatives if the States don't deal with this, should Congress step into that situation?

Mr. SHAD. Well, the SEC did propose——

Senator D'AMATO. And you're aware of the number of bills dealing with——

Mr. SHAD. Yes, I am. And—I believe it was about 1 year ago—we did propose that greenmail be proscribed. We tried to do it with a careful scalpel rather than a meat ax, to provide that companies could not repurchase shares at a premium from holders of over 3 percent of the stock that had been held less than 2 years unless they obtained shareholder approval or made a similar offer to all the shareholders.

Senator D'AMATO. That's a bill that I went to the floor with and I think this committee supported it.

What would be the downside on that?

Mr. SHAD. Well, I would only note the changes that are occurring. I also would add that since that proposal by the Commission—we've got two new Commissioners, so there's been a significant change, actually, in the composition of the Commission, and I can't express the views of the Commission today on that specific proposal.

I think there's merit in the proposal. There are offsets in terms of what this proscription does to inhibit the opportunities for the public market or investors.

Senator D'AMATO. Would it really limit the person who really intends an acquisition—would it impede that?

Mr. SHAD. Well, it wouldn't eliminate it, but it would change the risk-reward ratio. Greenmail is a way station, a profit opportunity en route, and to the extent you remove that——

Senator D'AMATO. That profit opportunity comes at the expense of shareholders.

Mr. SHAD. Well, the studies also indicate—first of all, the greenmail, you might say, puts the company in play. I don't want to be the advocate of greenmail, but I am trying to give at least the other side of the issue, as I perceive it.

Senator D'AMATO. I know, but what I am trying to draw out is what redeeming business feature does greenmail have. We just don't get enough time in some of these hearings, that's why the other 3 days are going to be necessary, and I'd like people like Boone Pickens and others to try and answer that question as to what business feature is enhanced as a result of the practice of greenmail. How can you defend it?

Mr. SHAD. Many of the major mergers that have taken place might not have taken place but for greenmail. That is a strong statement, and I haven't done the supporting analysis, but I believe it's true. In the decision process, the fact that there is a way station en route, where you don't have to go full term, is a very important factor to be considered in judging whether to commit the resources and assume the risk and expenses of proceeding. It allows the possibility of making different decisions along the way as the market changes.

I'd also add that there have been other changes—the fact that companies are putting a sign on their door that they won't pay ransom for their stock, and so you better not waste your time coming after them.

DISENFRANCHISEMENT

Senator D'AMATO. Well, let's take the other side, the companies that are disenfranchising their stockholders.

Should the Congress be concerned about that? Should we act, if there is a failure of State legislatures to do so? Do you see a proliferation of multiple stock classes with disproportionate voting rights? Is it fair?

Mr. SHAD. I don't think it's fair. I think that the disenfranchisement—I believe I emphasized in my opening statement the most important statement I'll probably make here today. I'd like to repeat it. If these trends toward shareholder disenfranchisement are permitted to persist, a significant percentage of the investing public will have little or no voting rights and therefore, no bargaining position in a keenly competitive, complex economic environment, in which all others, management, employees, customers, and suppliers have significant bargaining rights.

If you want to provide an enormous disincentive for savings and investing, then give no bargaining position for that purpose. When you get a situation where the customers, the suppliers, the labor unions, the landlords, everybody is using whatever strength they have, and you have one element in this equation that has no bargaining position, tell me where it's going to give. I'll tell you where it's going to give. It's already giving. When I was on Wall Street, I was constantly trying to persuade companies not to do so-called AB capitalizations, and oftentimes, companies do that on an initial public offering. So, therefore, at least the public is on notice from the beginning in those situations, that they're not going to have proportional voting rights in the company.

But even though I was opposed to it, I was ineffective in many cases in persuading companies not to go to an "AB capitalization," because at that time, and that's not many years ago, 4 years ago, 5 years ago, the market did not distinguish. You had A and B's, voting and nonvoting, and they sold at substantially the same price. Today there is a 3-percent discount in the nonvoting stocks, and I believe that discount will continue to increase as people assess the consequences of having no bargaining position.

Senator D'AMATO. Well, let me ask you, should this be the subject of a 19(c) proceeding on behalf of the Commission, if we see this moving in this pattern? I see frenzied activity on the part of so many corporations who are moving into these defensive postures. Whose interests are served? Maybe corporate managers are, but the governance that we have traditionally seen and the accountability, I think, is certainly fractured, should this be the subject of a 19(c) proceeding?

Mr. SHAD. I would tend to favor at this point in time taking into account, first of all, the shareholders' vote on these decisions to recapitalize the company. They approve supermajority and fair price amendments to the charter and bylaws. And I think a very notable, powerful response is coming, I've already seen evidence of it, and that is when the State pension funds, over $100 billion, start forming together and saying, "Look, this is outrageous. These are"—I don't want to state their case, but in any case, they are expressing concerns, they are taking a harder look at this. You've got

some of the major and most successful equity private funds, such as Battery March with $11 billion of equity capital under management, stating that they will oppose all of these antitakeover provisions, charter and bylaw amendments.

So you know, the market, the public is coming around, I would say, is increasingly militant and responsive, I think. So I have more confidence, at least at the present time, based on the facts to date, in the marketplace's ability to react than in formal legislation.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Chairman Shad, last year you wrote an article entitled "The Leveraging of America," where you expressed concern about a whole series of problems in connection with the takeover. No. 1, the debt that is used to retire equity in a number of these deals, you expressed concern about, and I thought you were absolutely right. As you know, in the Phillips attempted takeover, it didn't succeed, but it resulted in a conversion for Phillips, from having 75 percent equity and 25 percent debt to just about the reverse.

EXCHANGE OF $90 BILLION EQUITY FOR $90 BILLION DEBT

Mr. Lipton, who testified yesterday, and who has had enormous experience in this, said that it almost always results in an increase in debt and a diminution in equity. In fact, in 1984, there was an exchange with corporate America of $90 billion in equity for $90 billion in debt, much of which was because of takeovers, either threatened or consummated. He also said that the theory that contested takeover disciplined incompetent management is of limited veracity, and you also said that the threat of being taken over is an inducement to curtail research and development, plant rehabilitation and expansion and other programs entailing current costs for long-term benefits. That's quite a list of indictment against takeovers.

I am wondering what other problems, if any, you associate with some of these takeovers, and more specificially, how you would address some of those issues you've raised, if you oppose the legislation we've introduced.

Mr. SHAD. Well, which legislation? There are so many. Your bill? Your bill really doesn't address the leverage aspect, does it?

Senator PROXMIRE. No; it was on takeovers. Anything on takeovers is going to address the whole problem.

Mr. SHAD. Let me try to balance the two issues. Increased leverage against capital formation. The prima facie case is made up front. The tender offers, takeovers create capital, in the sense that there is a big premium up front, an average of over 30 percent for the targets, and an enhancement of the bidder's shares by about 9 percent, and when you consider the bidder is usually larger than the target, the proportionate dollar values aren't that far apart. So a self-evident fact is that there is an enormous amount—billions of dollars—of additional capital created annually for the benefit of the shareholders, which they immediately reinvest into other securities or put into the banks; so it gets back into the system.

So that is the affirmative argument. The risk argument——

Senator PROXMIRE. Let me just interrupt at that point to ask you, do we really create capital on that basis or do we absorb capital from other purposes and put it into the takeover effort, and so forth?

Mr. SHAD. I believe that capital formation is incidental income. It is the saving that goes into the system.

Senator PROXMIRE. All right. How does this increase saving?

Mr. SHAD. Well, it enhances the value of those savings which is just the very reason that you save. If you are going to defer consumption, to put your savings someplace, and you put them into sterile values that don't have any enhancement, then that's a pretty ineffective utilization. If you put them into equities that go up in value, that is capital formation. At the end of the result, the Nation is richer. It has more value in expendable funds than it had before.

Senator PROXMIRE. Well, it bids the price up. In that sense, you have a higher value, but it doesn't increase earnings. It doesn't increase research and development. It increases real wealth, does it?

Mr. SHAD. Yes, I believe it does. You say that the merger itself and whatever they do afterwards doesn't create wealth. I am not talking about that. I am talking about the creation of wealth at the point when $100 billion, approximately, last year, of enhancement of equity values occurred as the result of tender offers. I think that is an enormous enhancement of value. And it is part of the capital formation process. When you invest, there are two sources of return. One is the dividend and the other is appreciation. This accelerates the appreciation.

Senator PROXMIRE. You may have a new magic here. Just rub the old Aladdin's lamp and come up out of somewhere with an enhanced value without any real work, without any research, without any development, without any people being hired to increase the wealth in this way. You just do it by a psychological attitude that pushes prices.

Mr. SHAD. It would not work but for the conviction of those who risk the capital to finance these transactions, both as equity and debt lenders. The conviction is that they can redeploy the assets at a better rate of return. You can't justify it otherwise; and if you're wrong, you're going to pay the price, the lenders are, as well as the equity owners.

ATTEMPTED TAKEOVER OF CBS

Senator PROXMIRE. I agree with you, you can't justify it otherwise, but I think you can justify it this way.

But let me ask you this. I am very concerned about the attempted takeover of CBS by right-wing organizations. In my view, that would be a major setback for a free press and a very, very bad precedent. Since the takeover campaign has been going, the price of CBS has steadily increased.

Does the SEC have any evidence that the steady and spectacular advance in the price of CBS stock reflects acquisitions by the takeover forces?

Mr. SHAD. Well, if it would, it wouldn't be illegal.

Senator PROXMIRE. I didn't ask that. I asked whether it was.

Mr. SHAD. I was just being reminded of a fact that I'm well aware of, that Ivan Boesky has about 8.7 percent, and they've turned down his attempt at a greenmail transaction or representation or even meeting with him.

Senator PROXMIRE. Do you have this matter under surveillance?

Mr. SHAD. Well, we neither admit nor deny whether we have got matters under inquiry.

Senator PROXMIRE. What responsibility, if any, do you think the Federal Communications Commission should have with respect to this kind of takeover?

Mr. SHAD. I'm not an expert on the FCC.

Senator PROXMIRE. At any rate, you do agree that the SEC does have a degree of responsibility?

Mr. SHAD. We are very sensitive to significant developments in the marketplace, and I would place this in that category; yes, sir.

Senator PROXMIRE. But it would be in the same category as any corporate takeover? Simply because it's a very important element of the media and of informing the American people on what's going on in the world, what's going on in their country, wouldn't give it any enhanced status.

Mr. SHAD. No, it wouldn't. The SEC is an apolitical agency. We're a law enforcement agency, and we try to be responsive, regardless, and we have been responsive, as you well know. We've brought actions against some very prominent people in the administration on one side, as well as former prominent people on the other side of the aisle. So we have no ax to grind, in terms of whether it's liberal or conservative in its direction.

Senator PROXMIRE. Your agency voted by a 3-to-2 vote to intervene against so-called poison pill charters in a case before the court. I understand a poison pill charter requires a bidder to pay a substantial premium to stockholders, unless the bid was proved by the corporate directors.

Now what were the views of the two dissenting Commissioners on the proposed poison pill charters? You voted with the majority in that case.

Mr. SHAD. Yes; well, are you addressing the Delaware amicus brief that we filed?

Mr. Goelzer, did we have any dissents on that amicus brief?

Mr. GOELZER. Yes; that has been publicly reported.

Mr. SHAD. OK. Well, in that case, would you respond to this question, please.

The question is: What was the position of the two dissenters?

Senator PROXMIRE. Yes; the question was: What was the views of the two dissenting Commissioners in that case?

Mr. GOELZER. I don't know that I can answer that question, Senator, beyond the fact that they felt that we shouldn't file the brief. They felt it was basically a matter of State law that we shouldn't participate in. I am not in a position to answer the question more specifically. They did vote against the filing of the brief.

Senator PROXMIRE. All right, I understand that, and could you make those views available to us for the record?

Mr. SHAD. Yes; and I would interject that I supported it, notwithstanding the fact that there was very little precedent for the SEC entering an amicus brief in a State court, and there were Commis-

sioners—I am not sure that it was fully ventilated or not, but there were people that felt that we were going too far in entering into State court, but I'd rather get the specific answer from those who dissented.

[The following information was subsequently submitted for the record:]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

6-6

June 5, 1985

Senator William Proxmire
Dirksen Senate Office Building
Room SD-530
Washington, D.C. 20510

Dear Senator Proxmire:

At the April 4, 1985, Subcommittee on Securities hearing on corporate takeovers, you requested that I provide, for the record, the views of the two commissioners who dissented from the Commission's decision to file a brief amicus curiae in Moran v. Household International, Inc., a case pending in the Delaware Supreme Court. As discussed at the hearing, Commissioner Charles L. Marinaccio and Commissioner James Treadway voted against the filing of this brief.

In Moran, the Delaware Chancery Court upheld Household's adoption, without any shareholder vote, of a "poison pill" plan by Household International's directors. In its brief, the Commission argued that Household's "poison pill" would bar all hostile takeovers for Household; deter proxy contests; and entrench Household's management. The Commission's position is that, for these reasons, Household's unilateral action is not in the best interest of the Household shareholders and is contrary to the philosophy of informed shareholder consideration of tender offers which underlies the Williams Act.

Both Commissioners Treadway and Marinaccio preferred that the Commission not take a position on a matter of state law. See 17 Sec. Reg. & L. Rep. (BNA) 481 (March 22, 1985). In addition, Commissioner Treadway has stated that he does not believe that the Moran decision permits management to absolutely entrench

itself. See 17 Sec. Reg. & L. Rep. (BNA) 400 (March 8, 1985). Also, on March 21, 1985, during a hearing before the House Subcommittee on Telecommunications, Consumer Protection and Finance, Commissioner Marinaccio reiterated that he did not believe that the Commission should participate in a state court proceeding on a matter of state law and added that he believes that the Delaware Chancery Court was correct in its reading of the business judgment rule in this case.

The Commission's amicus brief, a copy of which is attached, points out that two of the members of the Commission "expressed the view that Household's plan would not allow a board to reject a fair offer for the company, and thus do not believe it tremendously enhances management's ability to block tender offers." Moran v. Household International, Inc. Brief of the Securities and Exchange Commission as amicus curiae, at p. 29, n.29 (filed March 19, 1985). This explanation of the reasoning of the two dissenting commissioners is a reference to the views of Commissioner Marinaccio and Commissioner Treadway.

I hope that this information is helpful to you and to the Subcommittee. Please do not hesitate to contact me if I may be of further assistance.

Sincerely,

Daniel L. Goelzer

Daniel L. Goelzer
General Counsel

Attachment

cc: Senator Alfonse M. D'Amato
Chairman, Senate Subcommittee on Securities

SUPREME COURT OF THE
STATE OF DELAWARE

No. 37, 1985

JOHN A. MORAN, et al.,

Plaintiffs-Appellants,

v.

HOUSEHOLD INTERNATIONAL, INC., et al.,

Defendants-Appellees.

On Appeal from the Court of Chancery of the
State of Delaware in and for New Castle County

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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March 19, 1985

SUPREME COURT OF THE
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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION AND PRELIMINARY STATEMENT

The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, including federal law regulating tender offers, submits this brief as amicus curiae. Although the Commission does not argue that this case directly involves application of the federal securities laws, the case does involve securities activities regulated by those laws. As a result of its experience in drafting, administering, and enforcing those laws, the Commission has formulated views that are relevant, and which the Court may find helpful, in the resolution of this important case.

The issue before this Court is the validity of action taken by the board of directors of defendant Household International, Inc. in adopting what may be the most potent defense yet devised to tender offers, a "poison pill" plan

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that will, in our view, virtually eliminate hostile tender offers for Household, or for any other company that adopts it. The plan will also deter proxy contests by persons seeking to oust Household's management. The effect of the plan thus will be to entrench management, and usurp to Household's board the shareholders' right to determine who will manage the company. The Chancery Court below held that adoption of this plan by Household, solely by vote of its board of directors and without shareholder approval, was in the shareholders' interests, and thus was a reasonable exercise of the Household board's business judgment.

The Commission's interest in this case arises out of its legislative, administrative and litigation activities with respect to tender offers over the past twenty years. The Commission played a central role in the drafting and adoption of the Williams Act, the principal federal statute regulating tender offers, and administers that statute. The Commission has promulgated rules governing the conduct of tender offers under the Williams Act, has litigated numerous aspects of federal tender offer regulation, and has advised Congress on the need for additional federal law in this area. In addition, the Commission has conducted studies on the effects of tender offers and defenses to such offers.

The Commission's consistent view, and the view of Congress in adopting the Williams Act and of the courts in applying it, has been that it is in the interest of shareholders to be able to consider tender offers on their merits. Congress structured the Williams Act so as to maintain a balance between bidders and management, allow both sides to present their case to the share-

holders, and leave it to the shareholders to decide whether to accept or reject the offer. The Commission has, through years of administration and enforcement under the Williams Act and extensive study of tender offers, adhered to this principle.

Based on our experience in this area, it is our view that the Household plan would deprive shareholders of an opportunity to consider virtually all hostile tender offers, would also have a significant deterrent effect on proxy contests against management, would thereby entrench management against efforts to oust it, and thus is not in the shareholders' interests.

We do not, in fact, read the Chancery Court's decision as holding that a plan with this broad effect in blocking virtually all hostile tender offers, and in deterring proxy contests, is in the shareholders' interests or is justified. Rather, the defendants argued below that the Household plan is justified because its only effect is to prevent shareholder consideration of certain types of tender offers they contended are "coercive." The Chancery Court held that the plan was justified because its effect is limited to such offers. Had the Chancery Court not reached this mistaken conclusion, it might well have held that the plan is not in the shareholders' interests. We do not believe that the plan has the limited effect ascribed to it by the Chancery Court, or that it is in the shareholders' interests, and we urge that the decision of the court below be reversed. 1/

1/ In addition to the business judgment rule issue, this case also raises a number of other issues. The Commission expresses no views on those issues.

STATEMENT OF THE CASE

This is an appeal by the plaintiffs from a judgment of the Court of Chancery of the State of Delaware in and for New Castle County denying, after trial, plaintiffs' challenge to the validity of a preferred stock rights dividend plan (the "Rights Plan") adopted by the board of directors of Household International, Inc. ("Household") without shareholder consideration. In sustaining the Rights Plan, the Chancery Court held, inter alia, that adoption of the plan was reasonable under the Delaware business judgment rule.

A. Facts 2/

Household is a diversified holding company incorporated in Delaware. Its principal subsidiaries are engaged in financial services, transportation and merchandising, and include a finance company, a car rental company, and a grocery chain (Op. 2). 3/ Household has acquired this conglomerate status as "the result of a series of acquisitions in recent years" (id.).

In February 1984, Household's management became concerned about the company's vulnerability as a takeover target and began considering various charter amendments which would render a takeover more difficult (Op. 3). It asked a leading proxy consultant to determine the likelihood of shareholder approval of one possible charter amendment, a so-called fair price amendment

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2/ The Commission expresses no view as to the underlying facts concerning the events leading to the issuance of the rights, or the structure of the Rights Plan, and relies, to that extent, on the facts as found by the Chancery Court.

3/ References to the Slip Opinion of the Chancery Court are Op. —; references to testimony in the record are cited by witness name, transcript volume number, and page number, as in, for example, Clark VI 75; references to plaintiffs' exhibits are PX ——, and to defendants' exhibits are DX ——.

(id.). 4/ When the consultant reported that such an amendment would "barely" obtain shareholder approval, management dropped any immediate plans to seek shareholder approval of defensive charter amendments (id.).

Management's concern over a takeover subsequently increased when one of its directors, plaintiff John Moran, had his company, plaintiff Dyson-Kissner-Moran Corporation ("DKM"), perform financial studies that showed that Household's stock was "significantly undervalued in relation to" what could be obtained if the conglomerate were broken up and some of its constituent companies sold off (Op. 3). Moran spoke with Household's chairman, defendant Donald Clark, and its chief financial officer about the possibility of a friendly buy-out by Moran and his company (id. 3-4). This proposal, however, "never got beyond the discussion stage" (id. 4), and "there is no indication that Moran ever intended a hostile takeover of Household" (id. 5).

This management concern over a tender offer was also apparently intensified by a letter Clark received on May 14, 1984, from a representative of the Murchison Group, a Dallas-based investment group, requesting a meeting to discuss a matter of "mutual interest" (Op. 4). Clark refused to meet, and the matter apparently was not pursued further (id.).

Household's management sought advice on defenses against tender offers from a law firm and an investment banking firm. Those two firms prepared a possible defensive strategy to be presented to the Household board on August

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4/ A fair price amendment is, generally, a charter amendment that requires a tender offeror, in any subsequent acquisition of shares (such as in a merger), to pay for those shares at least as much as the highest price paid in the tender offer. See R. Winter, M. Stumpf & G. Hawkins, Shark Repellants and Golden Parachutes 44-45 (1983).

14, 1984. Among the proposed defensive tactics was the Rights Plan. On August 7, a three-page summary of the plan was sent to Household's directors (Op. 5-6).

At the board meeting on August 14, following a presentation of the plan and a brief discussion of its merits, a majority of the board approved the plan (Op. 6,9). Plaintiff Moran, who during the discussion voiced vigorous opposition to the plan, voted against it, as did one other director (id. 9-10).

The Rights Plan is one variation of a new takeover defense referred to colloquially as "poison pills." In essence, a "poison pill" is a stock, a warrant, or a right that is issued to a target company's shareholders. The "poison pill" generally only becomes activated in the event of a tender offer, the acquisition of a specified block of stock by an investor or group of investors, or the formation of a group of investors holding a specified block of stock (such as a group formed to fight a proxy contest). Once activated, the poison pill, for reasons that vary according to the precise plan, makes the target company a far less attractive takeover candidate.

The Household Rights Plan is an unusually potent poison pill scheme. The plan involves the issuance of stock rights -- on their face rights to purchase $100 worth of Household preferred stock -- to Household's common stockholders (Op. 7). These rights were, when issued, not separable from the common stock and not exercisable (id. 8).

The Plan provides, however, that the rights will detach from the common stock and become exercisable if anyone (a) makes a tender offer for at least 30% of Household's stock, (b) obtains 20% of Household's stock, (c) acquires the right to purchase or to vote 20% of the stock; or (d) forms a group holding 20% for the purpose of acting together (Op. 8).

Even then, however, the rights would not be exercised, since the $100 exercise price for the preferred stock is conceded to be at present very much an "out of the money" price (Op. 7).

The rights are of consequence in one event. If a merger is effected in which Household is absorbed by an acquiror, such as in a merger following a tender offer, the rights will "flip-over" so that the holders will be able to purchase, for $100 per right, $200 worth of the acquiring company's stock (Op. 8). In effect, the acquiring company will have to pay a net of $100 worth of stock for each right held by Household's shareholders. As the Chancery Court found, "[t]he resultant dilution of the acquiror's capital is immediate and devastating" (id.). This dilution effect, which is not common to all poison pill plans, 5/ means that were all of the rights issued by Household exercised, the acquiror would be forced to pay an extra $6 billion for

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5/ There are other poison pill plans which provide the target's shareholders with stock which may, in the event of a takeover, be redeemed at a price equal to "the highest price per share paid for the target's shares in the year the acquiring entity gained control." Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred, 97 Harv. L. Rev. 1964, 1965 (1984). These plans do not require bidders to pay enormous and prohibitive premiums for a target, as the Rights Plan does; they act like "fair price" amendments (see n.4 supra) by requiring a bidder to pay the same price to all shareholders -- thus deterring those bidders who seek to save money by offering a high premium for less than all of the stock. See id. at 1967; Finkelstein, Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law, 11 Sec. Reg. L.J. 291, 300 (1984).

the company, which at the time the plan was adopted had a market value of approximately $1.8 billion 6/.

This "flip-over" will, however, only occur, as a practical matter, if the acquisition is a hostile one not approved by management. Since the rights may be redeemed by the Household board for the relatively nominal amount of fifty cents each at any time before one of the 20% triggering events noted above occurs, the board can remove the "poisonous" effect of the plan for any take-over of which it approves (Op. 9). Thus, the plan forces any tender offeror contemplating a merger with Household (which, as discussed below, includes virtually all tender offerors) to first seek and obtain board approval. As Clark, Household's chairman, explained in a letter sent to shareholders on the day the plan was adopted: "[t]he rights will not prevent a takeover of Household International, but should deter any attempt to acquire your company in a manner or on terms not approved by the Board" (PX 211, at 2) (emphasis added).

B. Proceedings in the Court of Chancery

Plaintiffs Moran and DKM filed a complaint in the Court of Chancery on August 17, 1984, seeking to invalidate the Rights Plan and to permanently enjoin Household from pursuing it in the future. 7/ Plaintiffs argued, among other things, that issuance of the stock rights was beyond the power of the

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6/ Household had approximately 60,000,000 shares of common stock outstanding, which were trading at a price of around $30 per share. Household issued 60,000,000 rights, one per share of common, each costing an acquiror a net of $100 in payment to the right holder following a "flip-over."

7/ Plaintiff Gretl Golter, holder of 500 shares of Household, was subsequently permitted to intervene as a plaintiff (Op. 1).

board of directors, as it was designed to entrench the board and management against changes of control. They also argued that the plan improperly altered fundamental shareholder rights by depriving shareholders of the ability to receive and consider hostile tender offers and by severely limiting the ability of shareholders to engage in proxy contests. The effect on proxy contests, the plaintiffs charged, would result from the fact that the rights would become exerciseable and non-redeemable in the event a group controlling 20% of Household's stock were formed, or in the event any person acquired the "right to vote" 20% or more of the stock. By deterring formation of groups controlling 20% or more of the stock, they argued, the likelihood of insurgent success in proxy contests would be greatly diminished. Furthermore, by making the rights non-redeemable when anyone acquires the right to vote 20% or more of the stock, they argued, proxy contests would be eliminated, since any successful proxy contest would involve acquisition of the right to vote, through proxies, more than 20% of the stock.

Defendants, for their part, claimed that the issuance of the stock rights was protected by the Delaware business judgment rule as a reasoned and deliberate approach to deter harm to the corporation and its shareholders from abuses which they claimed are common in corporate takeover battles.

On January 29, 1985, after a nine-day trial, the Court of Chancery entered judgment for the defendants, upholding the validity of the Rights Plan on the ground that the Board acted within its authority in adopting the plan (Op. 40-41). The court held that under the Delaware business judgment rule, because the Rights Plan would "result[] in a fundamental transfer of power" (id. 36) from the shareholders to the directors with respect to who will be the "prime negotiator" of certain tender offers, the burden was on Household and its

directors to go forward with evidence to establish the reasonableness of the plan (although they would not bear the burden of persuasion on this issue). The court found that the defendants met this burden. It said that the board had adopted the plan in order to deter two-tier tender offers, in which the offeror proposes to buy part of the target company's stock for cash, and then follows the offer with a merger to acquire the remaining shares. Although the court found that because of the "devastating" dilution effect of the "flip-over" provisions of the rights in the second-step merger, the Rights Plan will "virtually eliminate hostile two-tier offers for Household," it held that this was reasonable since "the coercive nature of such tender offers * * * is well documented" (id. 43). The Court also held that any deterrence of proxy contests resulting from the effect of formation of a 20% group would be limited and "highly conjectural", since persons with less than a 20% interest in a company can be successful in waging proxy contests. This limited deterrent effect, the court held, had a rational purpose in preventing persons from making hostile two-tier tender offers (by deterring them from waging a proxy contest to redeem the rights), and thus was valid (id. 49).

ARGUMENT

THE RIGHTS PLAN, BY PREVENTING SHAREHOLDER CONSIDERATION OF VIRTUALLY ALL HOSTILE TENDER OFFERS, AND BY DETERRING PROXY CONTESTS AGAINST MANAGEMENT, DOES NOT SERVE THE SHAREHOLDERS' INTERESTS.

The Chancery Court held that in order to have the Rights Plan sustained, the Household board would have to show some evidence that "its approval of the plan was not motivated primarily by a desire to retain control but by a reasonable belief that the plan was necessary to protect the corporation from a perceived threat to corporate policy and effectiveness" (Op. 36-37). The court

concluded that the plan serves a reasonable corporate purpose because it protects shareholders from "coercive" hostile two-tier tender offers, which it found contrary to the best interests of the shareholders (id. 39, 43). 8/ The plan was never submitted to the shareholders for their consideration of this proposition. 9/ The court found that while the Plan would restrict a shareholder's ability to receive tender offers, that effect would be limited since the Plan's "impact is upon * * * only such a prospective purchaser who wishes

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8/ The Chancery Court used the pejorative term "coercive" because of its view that two-tier offers put extreme pressure on shareholders to tender, since shareholders realize that if they do not tender, they will almost certainly (although not necessarily) be offered less in a second-stage merger. The same holds true for partial offers, where the offeror tenders for part of the company's shares, and the non-tendering shareholders will be left in a minority position, perhaps with a thin or nonexistent trading market.

However, to a degree, all tender offers are "coercive" to the extent that they afford shareholders the opportunity to accept or reject substantial premiums within a specified time period. Thus, pressure always exists on the shareholder to take the premium. Indeed pressure to tender is the hallmark of a tender offer. The term "tender offer" is not defined in the Williams Act or in Commission rules. Rather its definition has been left to case by case development, and the chief criterion is pressure on shareholders. See, e.g., Panter v. Marshall Field & Co., 646 F.2d 271, 285 (7th Cir.), cert. denied, 454 U.S. 1092 (1982); Crane Co. v. Harsco Corp., 511 F. Supp. 294, 302 (D. Del. 1981).

9/ As noted, the board had determined, after seeking expert advice, that a fair price amendment, which is a far less potent takeover defense, but which would block two-tier offers, would "barely" obtain shareholder approval. Numerous shareholders or their investment advisers have strongly objected to the Rights Plan (see PX 251, 252, 253, 254, 257, 260, 312).

to pursue a hostile two-tier offer" (id. 44). 10/ The court also said that the plan would only have an "incidental consequence of limiting the proxy activity of those opposed to the Board's present policies" (id. 49).

The Chancery Court's decision seriously understates the impact of this plan. In fact, as we discuss below, the Rights Plan will deter not only two-tier offers, but virtually all hostile tender offers. It will also greatly diminish proxy contests by persons opposed to management. It is our view that the Household plan, by preventing shareholders from considering virtually all tender offers, unless the board of directors has first approved any such offer, by deterring proxy contests, and by thereby entrenching Household's management against efforts to oust it, is not in the shareholders' interests. The defen-

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10/ The defendants offered two other major rationales for the plan, neither of which was cited by the court below as justification for the plan. First, they argued that Household was vulnerable to a takeover by a highly leveraged acquiror, which would then sell off parts of the company at "distress" prices to pay off its debt (Def. Post-Trial Br. at 10-12, 15-16). But while Household was apparently vulnerable to a "bust-up" by an acquiror, that does not necessarily imply the liquidation at distress prices that defendants suggest. It could mean that this conglomerate was inefficient, and that its constituent parts, if sold or spun-off at a fair market price, could be operated more efficiently and profitably (see Jensen V 64-66). Since, as noted above, Household was not facing any actual hostile offer, this general concern that some heavily leveraged buyer might conduct such a distress sale (a concern that is shared by any potential target) could not justify deterring all hostile offers.

Second, defendants argued that the plan would give Household's shareholders an equity interest in any merged entity (Def. Post-Trial Br. at 62). That does not explain, however, why the plan not only gives shareholders the right to buy stock in the merged entity, but gives them the right to make a $100 per right profit while doing so. In fact, this profit would assure that no acquiror would allow the "flip-over" to take place, and would assure that Household's shareholders would not obtain an equity interest in the merged entity.

dants, in fact, did not argue below that such a broad effect on tender offers or proxy contests would be beneficial to the shareholders. Nor did the court so hold. The defendants argued, rather, and the court below found, that the deterrent effect of the plan would be far more limited, and that this limited effect justified the plan as being in the shareholders' interests (see, e.g., Def. Post-Trial Br. at 52-53, 62-63). Had the Chancery Court not misperceived the effect of the Rights Plan on the shareholders' ability to receive hostile tender offers and engage in proxy contests, it might well have concluded that the plan is not in the shareholders' interests, and thus is not justified.

A. It Is In the Shareholders' Interests to Be Able to Consider Hostile Tender Offers.

Our view as to the interests of shareholders, and as to the effect of the Rights Plan on those interests, is based on the Commission's experience in regulating tender offers at the federal level. The Commission has responsibility for administering the Williams Act in connection with tender offers, for enforcing the provisions of the Act, for evaluating various tactics by bidders and management in tender offers, and for formulating regulations and proposing legislation governing the conduct of tender offers. As a result of that experience, the Commission has gained extensive expertise in evaluating what type of tender offer process best serves shareholders' interests, and in determining what type of practices might prove inimical to those shareholder interests. We believe that the Commission's views are relevant to determining the outcome of this case, and that the Court might find it useful to consider these views.

For twenty years, Congress and the Commission have consistently held the view that tender offers can benefit shareholders by offering them an

opportunity to sell their shares at a premium, and by acting as a guard against the entrenchment of management, and that it thus is in the shareholders' interests to allow them the opportunity to consider and act on tender offers.

Prior to the adoption of the Williams Act in 1968, federal law had only peripheral application to cash tender offers, and the states, with the exception of Virginia, had not adopted tender offer regulation. 11/ As a result of this regulatory vacuum, a number of abuses by both bidders and management had developed — abuses which allowed bidders to place "undue pressure on shareholders to act hastily and accept the offer," 12/ and allowed management unfairly to deter shareholders from accepting offers on the basis of insubstantial or irrelevant arguments or by unfair practices that made the offer look unattractive. 13/

In adopting the Williams Act, Congress was concerned that shareholders should have a fair opportunity to consider tender offers on their merits. Congress found that "takeover bids should not be discouraged because they serve a useful purpose in providing a check on entrenched but inefficient management."

11/ In those instances where the tender offer took the form of an exchange of securities, the transaction was subject to the disclosure requirements of the Securities Act of 1933, 15 U.S.C. 77a et seq. See S. Rep. No. 550, 90th Cong., 1st Sess. 2-3 (1967); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 3 (1968). Virginia had passed its tender offer statute only 4 months before enactment of the Williams Act, and after Congress had conducted its hearings on the Act.

12/ Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcommittee on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess, 21, 35 (1967) ("Senate Hearings").

13/ See Senate Hearings at 3, 27, 60, 62, 196, 236; Speech by Commission Chairman Manuel Cohen before Association of the Bar of the City of New York, April 14, 1967, reprinted at Senate Hearings at 202, 204-05.

S. Rep. No. 550, 90th Cong. 1st Sess. 3 (1967) ("Senate Report"); see 113 Cong. Rec. 24664 (1967). Also, Congress did not want to deny shareholders "the opportunities which result from the competitive bidding for a block of stock of a given company" -- the opportunity to sell shares for a premimum over the market price. 113 Cong. Rec. 24666 (1967) (remarks of Senator Javits); Edgar v. MITE Corp., 457 U.S. 624, 633 n.9 (1982). 14/

The goal of this federal legislation is to allow shareholders to decide whether or not to accept a tender offer, without undue influence either by bidders or by management. Thus, tender offers are conducted through a national "market approach" in which the goal "is to get information to the investor by allowing both the offeror and incumbent management of a target company to present fully their arguments and then let the investor decide for himself." Great Western United Corp. v. Kidwell, 577 F.2d 1256, 1276 (5th Cir. 1978), rev'd on other grounds sub nom. Leroy v. Great Western United Corp., 443 U.S. 173 (1979) (footnote omitted). Unlike mergers, which are presented to the company's board of directors for approval, "[t]ender offers contemplate transfers of stock by shareholders to a third party and do not themselves implicate the internal affairs of the target company." Edgar v. MITE Corp., 457 U.S. at 645.

14/ The premiums that shareholders can realize in a tender offer are established beyond doubt. The Commission's Chief Economist, in a study of tender offers between the years 1981 and 1983, found that the shareholders received premiums over market value of, on average, 31.3% for partial offers, 55.1% for two-tier offers, and 63.4% for any and all offers. 49 Fed. Reg. 26755, 26760 Table 4 (June 29, 1984). The Supreme Court of the United States has also recognized that, where tender offers are blocked, "[s]hareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced." Edgar v. MITE Corp., 457 U.S. at 643.

In furtherance of this determination that the shareholders should have the opportunity to consider tender offers, Congress adopted a policy of "even-handedness," and structured the Williams Act so that neither bidders nor management would exercise undue influence over the process. The hearings leading to adoption of the legislation emphasized the need "to get information to the investor * * * and then to let the investor decide for himself." 15/ Then Commission Chairman Manuel Cohen testified before the Senate that the approach of the bill was "to provide the investor, the person who is required to make a decision, an opportunity to examine and assess relevant facts * * *" (Senate Hearings at 15). The House and Senate Reports on the Williams Act underscore Congress' intention that shareholders, informed through full disclosure by both sides in the contest, be the actual decision-makers in the tender offer process: "This bill is designed to make relevant facts known so that shareholders have a fair opportunity to make their decision." (Senate Report at 3; H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968)). See Edgar v. MITE Corp., 457 U.S. at 633-34; Rondeau v. Mosinee Paper Corporation, 422 U.S. 49, 58 (1975); Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 26-31 (1977); Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 760 (2d Cir.), cert. denied, 104 S. Ct. 550 (1983).

15/ Takeover Bids: Hearings on H.R. 14475 and S. 510 Before the Subcomm. on Commerce and Finance on the House Comm. on Interstate and Foreign Commerce, 90th Cong. 2d Sess. 4, 47-48 (1968); Senate Hearings at 17, 19, 25, 182. See Great Western United Corp. v. Kidwell, 577 F.2d at 1279-80.

After more than fifteen years of administering the Williams Act, the Commission has adhered to the view that shareholders are not served by practices that would preclude shareholder consideration of tender offers. The Commission continues to believe that it is "necessary and appropriate in the public interest and for the protection of investors" to "ensure a balance between the interests of the person making a tender offer and the management of the company whose securities are being sought." Securities Exchange Act Release No. 16384, 44 Fed. Reg. 70326, 70326 (Dec. 6, 1979).

B. The Rights Plan Is Contrary to Shareholder Interests In that It Deprives Shareholders of the Opportunity to Consider Hostile Tender Offers and Limits Their Ability to Wage Proxy Contests Against Management, and Thereby Entrenches Management.

In furtherance of the Congressional and Commission view that it is in the shareholders' interests to be able to consider tender offers, the Commission has appeared as amicus curiae on a number of occasions to challenge action that would deprive shareholders of this choice. Although those cases involved challenges to statutes under the Supremacy Clause, rather than the validity of board of directors action addressed here, the fundamental principle of those cases is instructive in this case. That principle is that policies or practices that give management the ability to remove tender offers from shareholder consideration frustrate the shareholder choice that Congress and the

Commission have viewed as being in the shareholders' interest. See Great Western United Corp. v. Kidwell, 577 F.2d at 1279; Edgar v. MITE Corp., 457 U.S. at 633-39 (opinion of Justices White and Blackmun and Chief Justice Burger). See also National City Lines, Inc. v. LLC Corp., 687 F.2d 1122, 1129-30 (8th Cir. 1982); Kennecott Corp. v. Smith, 637 F.2d 181, 189-90 (3d Cir. 1980).

This case involves, if anything, a practice far more extreme than what was at issue in the above-cited cases. The state statutes at issue in those cases generally only gave management added time, by requiring pre-commencement disclosure by bidders or by allowing management to seek a fairness hearing, in which to attempt to defeat a tender offer. The Rights Plan, in contrast, gives Household's management an absolute veto over any tender offer. This plan simply will not allow a non-management approved tender offer to be made for Household. In addition, the plan will have at least a significant deterrent effect on proxy contests and consent solicitations against management. The ultimate effect of this plan will be to entrench Household's management, or the management of any company that adopts such a plan, against virtually any attempt to oust it. The Household board has, by this plan, usurped the shareholders' right to control who will manage their company.

To begin with, the plan will not, as the Chancery Court concluded, block only two-tier offers. It will block virtually all hostile tender offers. In understanding this effect, it must first be recognized that "[t]here is apparent agreement that the primary goal of a potential acquiror is to achieve 100% ownership" of a target company's stock (Op. 41). Tender offer statistics compiled by the Commission's Chief Economist show that pure partial tender

offers, in which the offeror has as its goal less than 100% ownership, are relatively infrequent, and have been declining in frequency in recent years. 16/ One of Household's own experts at trial, Jay Higgins, managing director of the mergers and acquisitions department of Salomon Brothers, testified that he is aware of no case where a successful offeror for a company, like Household, valued at more than $1 billion was willing to settle ultimately for less than 100% of the company (Higgins VII 159-60). But even if an offeror would make such a partial offer for a company of this size, and be willing to hold less than 100% indefinitely, it would not wish to be foreclosed from later acquiring the remainder of the stock. Thus, in any event, an offeror will be strongly deterred by any plan that prevents it from acquiring 100% of the company.

An offeror has two basic ways in which it can acquire 100% of a company. First, it can make a tender offer for part of the company's shares, perhaps 51%, and then obtain the remaining shares by a second stage merger. In a "two-tier" offer the merger will closely follow the offer. But even in a "pure partial" offer, the acquiror may effect a second step merger sometime after the offer. As the Chancery Court recognized, the Rights Plan will "virtually eliminate" such offers (if hostile) by making the second step of the offer, the merger, excessively expensive (Op. 40).

16/ In a report entitled "The Economics of Partial and Two-Tier Tender Offers," 49 Fed. Reg. 26755 (June 29, 1984), the Office of the Chief Economist reported that between 1981 and 1983, among 148 tender offers studied, only 25 were partial offers where a followup merger for the remaining shares was not conducted "closely following" the offer. Id. at 26760 Table 1. Furthermore, the percentage of such offers declined steadily throughout those three years. In 1981, they accounted for 15 out of 64 offers studied; in 1982 they accounted for 7 out of 51 offers studied, and in 1983 only 3 out of 33 offers studied. Id.

Alternatively, the offeror can make an "any and all" tender offer, in which the offeror agrees to accept all shares tendered by shareholders. The Rights Plan will deter these types of hostile offers as well. This is because while, in theory, an any and all offer could lead to an offeror being tendered 100% of the stock, it is not disputed that in practice 100% of the shares will not be tendered, and the offeror must still undertake a merger in order to obtain the untendered shares. But the Rights Plan will render any substantial merger financially impossible, and thus will deter any and all offers. 17/

No justification has been advanced for Household adopting a plan that blocks any and all offers. The defendants have not claimed that they needed to protect shareholders from any and all offers, and there are other plans that the Household board could have adopted that would have deterred two-tier

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17/ In fact, since any and all offers constitute the vast majority of tender offers, the impact of this type of plan, if widely adopted, in deterring any and all offers will be far greater than its effect on the two-tier offers at which the plan is assertedly directed. The Commission's Chief Economist found that of 148 tender offers made between 1981 and 1983 that were studied, 91, or 61.5%, were any and all offers, while 32, or 21.6%, were two-tier offers. 49 Fed. Reg. 26755, 26760 Table 1 (June 29, 1984). The Chief Economist's latest statistics show that the percentage of two-tier offers dropped precipitously in 1984, to 7.5% (6 out of a total of 80 offers).

Beyond deterring tender offers, the plan will also deter persons from making substantial open-market purchases, or other purchases, of Household stock as a first step towards acquiring 100% of the company's stock, since any purchases of 20% or more of Household's common stock will render the rights non-redeemable, and highly potent in any follow-up merger. It is not uncommon for such purchases to precede a tender offer and follow-up merger. See Freund & Easton, The Three-Piece Suitor: An Alternative Approach to Negotiated Corporate Acquisitions, 34 Bus. Law. 1679 (1979).

offers, without deterring any and all offers. 18/ In fact, the defendants did not attempt to argue below that this effect on any and all offers was necessary or justified. They suggested instead that there are ways — albeit untested and highly uncertain ways — to circumvent the plan's extreme reach. However, the evidence shows that defendants' suggestions are unworkable.

First, defendants suggested that an any and all offer could be made conditional on the offeror being tendered at least 95% of the rights, thus limiting the dilution effect of a second step merger to 5% of the rights, or, in this case, "only" $300 million or so. 19/ The flaw in this theory is that it is almost certain not to work. The Chancery Court noted that "[t]he market professionals on both sides agree that a high minimum offer for a company of Household's size has never been attempted and it is questionable that such an approach would succeed" (Op. 40). If anything, that summary understates the testimony.

18/ For example, Household could have adopted a "poison pill" plan that would force bidders to pay the same price for all shares (see n.5 supra). Such a plan would have deterred two-tier offers by precluding an offeror from paying a lesser amount in the second-stage; it would not, however, deter any and all offers, where the bidder is already willing to pay the same amount to all shareholders. In taking note of this less restrictive alternative, we express no view as to whether adoption of such a plan would be a reasonable exercise of the board's judgment.

19/ The board was told, at the time it approved the plan, that an offeror could compensate for the dilution from merging out the remaining 5% of the rights by reducing the amount paid in the tender offer (PX 203 at 9). Even if this would work, however, the effect would be that the offeror would be forced to pay substantially more to the small number of shareholders who did not tender their rights, while paying less than it would otherwise to the 95% of shareholders who did tender their rights. It is difficult to see how a plan that leads to such results can be said to be in the best interests of the shareholders as a whole.

Plaintiffs' principal market expert was Alan C. Greenberg, chief executive officer of Bear Stearns & Co., and a risk arbitrageur, whose profession calls for the objective evaluation of the likelihood that tender offers will or will not succeed (Greenberg IV 64-66). Greenberg testified that a hostile offer conditioned on even 80% to 90% being tendered, let alone 95%, would be "[t]otally hopeless" (id. 73). He explained:

> "[t]he only company I've ever heard of that have gotten 80 or 90 percent is when they have made a tender and they already own 70 or 65 or 75 percent, and you tender for a 'ittle bit more for accounting reasons to get above 80. It's totally unrealistic. A certain number of shareholders are out of the country. A certain number of shareholders have lost their certificates. A certain number of shareholders wouldn't tender to anybody for any price" (id. 73-74). 20/

The defendants' market expert, Jay Higgins, also testified that such a high minimum offer, even one for an 80% minimum, is unheard of. He testified that "[c]ertainly anything like that is very unusual. You would be advised not to do it because it would be self-defeating" (Higgins VII 184-85). 21/

20/ The likelihood of reaching 95% may be virtually nil if management and its allies control significant amounts of stock. Household's management owns or has the right to acquire 2.3% of Household's stock (PX 5 at 12). Its employee benefit plans own approximately 4.6% (PX 41 at 3). Significantly, on the same day the Rights Plan was adopted, the board gave employees, who are likely to side with management (see Wilcox IX 93-95), the right to control tendering of those shares (Op. 6-7), rather than vesting control over such tenders in an independent trustee.

21/ In fact, a high minimum conditioned offer for the rights is even less likely to succeed than in the usual offer for stock. In the usual offer, the largest premium for the shares is offered up front, in the tender offer, with a lesser premium (or none at all) offered in the second-stage merger. Individuals know that if they do not tender, they are likely not to get the best premium. Even though that "front-end loaded" aspect of the usual offer provides an incentive to tender, a 95% condition is still virtually impossible to meet. Here, in contrast, investors know that if

(footnote continued)

The defendants' alternative position, again discussed by Higgins, is that any and all offers can be made either because if a fair offer is made, the board will relent, 22/ or even if the board does not relent of its own will, a high percentage of tenders (even if a 95% condition cannot be met) may persuade the board of directors to redeem the rights and allow the offer to go forward. Higgins was, however, highly equivocal and uncertain about how this might be brought about. He suggested that "something will happen. I don't know exactly what, but something will happen" (id. 189). 23/

21/ (continued)

they do not tender their rights, and the offer succeeds, they are guaranteed a $100 per right profit in the second-stage merger. Thus there is an incentive not to tender, since whatever premium a right holder could get by tendering is sure to be far less than $100. The only reason a shareholder would tender in these circumstances would be a belief that his tendering would make the difference between the offer succeeding (and thus providing some premium) and failing (and providing no premium at all). But it is unlikely that any individual shareholder who holds a small number of shares will believe that his decision to tender will make such a difference (see Jensen IV 179-88).

22/ Household argued below that "the board must be presumed, under the business judgment rule, to have a willingness to consider all takeover proposals and redeem the rights to permit an attractive takeover bid to proceed" (Op. 25). This Court has long adhered to the conclusion that boards of directors, when faced with contests for control, cannot be presumed to act in the shareholders' interests. See Bennett v. Propp, Del. Supr., 187 A.2d 405, 409 (1962) ("when a threat to control is involved," the "directors are of necessity confronted with a conflict of interest, and an objective decision is difficult. * * * Hence, in our opinion, the burden should be on the directors to justify [a defensive response] as one primarily in the corporate interest"); Cheff v. Mathes, Del. Supr., 199 A.2d 548, 554 (1964) (same).

23/ Higgins conceded, however, that if this unknown "something" did not happen, the offeror was taking "[a] tremendous downside risk" (id. 190) that after committing millions of dollars to the offer it would fail. Higgins also suggested that a tender offeror could bid for less than 100% of Household's stock, and simply be satisfied to hold less than 100%

(footnote continued)

One thing that is less likely to happen is a proxy contest, or the seeking of consents, by a shareholder to force redemption of the rights. The Rights Plan effectively prevents formation of a group of shareholders who hold 20% or more of Household's stock for the purpose of waging a proxy contest, or a consent solicitation, since formation of such a 20% group will trigger the rights and render them non-redeemable. The Chancery Court recognized that this would "deter the formation of proxy efforts of a certain magnitude" (Op. 48), but thought it "highly conjectural to assume" that it would prevent any particular proxy contest from being waged (id. at 148-49). But the effect of the limitation in inhibiting proxy contests, or consent solicitations, is beyond conjecture.

As defendants conceded below, the very reason why they chose 20% as the percentage of ownership that would trigger the rights is that "20% is a well recognized threshold for measuring control" of a company (Def. Post-Trial Br. at 57 n.*), and they wanted to prevent formation of "a group of shareholders committed by agreement to concerted action with respect to a block of stock large enough to be deemed effective control of Household" (id. at 58). Defendants cannot reasonably, on the one hand, argue that 20% ownership is a "threshold" of control of the company and concede that the plan was structured

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23/ (continued)

until the rights expire (id. 152-53, 194-95). He agreed, however, that he has never heard of such an offer being made for a company of Household's size (id. 159-60). Even if an offeror would be satisfied with making a partial offer, however, such a partial offer would be at least as "coercive" as a two-tier offer, see n.8 supra, and would run counter to the stated reason for the plan — to block coercive offers.

to prevent formation of a control group, but at the same time argue that prevention of the formation of a 20% group will not inhibit the ability of insurgents to win proxy contests.

In fact, the only empirical evidence in the record shows that the holding of 20% or more of a company's stock is a significant advantage in a proxy contest, and that limiting insurgents to less than 20% will greatly enhance management's ability to defeat a contest. This evidence (DX 39) was a study of 96 proxy contests between 1981 and 1984 that was prepared by one of defendants' experts. It showed that where insurgents held 20% or more of a company's stock, they were able to win a proxy contest (in whole or in part) 24/ or force a settlement with management 50% more often than where insurgents held less than 20%. 25/ Likewise, where persons waging a proxy contest against management held less than 20% of the company's stock, management won (in whole or in part) 44% of the time; where insurgents held more than 20% of the stock, management only won 19% of the time. While a group of shareholders could still be formed to oppose Household management, the Rights Plan, by holding such a group to below the 20% threshold, greatly diminishes the chance that they will be successful, and more than doubles the chance that Household's management will prevail in any such contest. The effect will be to make it far more likely that Household's shareholders will be unable to band together to oppose management successfully, and that Household's management will remain entrenched.

24/ In some cases, the contests involved more than one issue, and the insurgents won on only some issues.

25/ In the former situation, insurgents won or forced a settlement in 76.2% of the contests, while in the latter situation that rate was only 50.6%.

While such a deterrent effect itself is of substantial concern, the plan could in fact be read to mean that even if a proxy contest could be successfully waged without formation of a 20% group, any successful solicitation of proxies or consents will render the rights non-redeemable. The rights become non-redeemable whenever any person becomes the "Beneficial Owner" of 20% or more of Household's stock, defined in the plan to include any person who "has * * * the right to vote [the stock] pursuant to any agreement, arrangement or understanding" (PX 204 at 2-3) (emphasis added). But any person who wages a successful proxy contest or consent solicitation could be said to obtain, through an "agreement, arrangement or understanding" with shareholders, the "right to vote" their shares. Any person who, at the time of the shareholders' meeting, holds valid proxies for 20% or more of the company's stock would thus have the "right to vote" 20% or more of the company's shares. 26/ Yet

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26/ Defendants argued below that the receipt of proxies or consents from 20% of the shareholders would not trigger the rights because "[i]t is hornbook law that receipt of a proxy does not make the recipient the beneficial owner of the shares involved" (Def. Pre-Trial Br. at 50). But the Rights Plan does not require that a person become a beneficial owner in a common law sense; it specifically defines the term "Beneficial Owner" to include anyone who, pursuant to an "agreement, arrangement or understanding" has the "right to vote" stock. A proxy or consent can be construed to be such an agreement, arrangement or understanding. Even if, as defendants argued (id. at 51), there is no unconditional "right to vote" the stock so long as the proxy remains revocable, once the meeting commences the proxy holder's right to vote the shares clearly exists. The cases cited by defendants below (id. at 51 n*) are not to the contrary. Indeed, the first case they cite, Josephson v. Cosmocolor Corp., Del. Ch., 64 A.2d 35 (1949), said that the plaintiffs in that case "procured proxies from other record stockholders which, with the 6,000 shares [plaintiffs owned] gave them the right to vote more than 80,000 shares." Id. at 36 (emphasis added).

such a result will render the rights non-redeemable. Under such a reading of the plan, proxy contests or consent solicitations to force redemption of the rights will not be made. 27/

Even if proxy contests are only deterred, however, and not eliminated, the decision whether to redeem the rights will rest almost solely in the hands of the board. Household's view is, in essence, that the courts should wait and see how the board reacts to a specific offer before passing judgment on the validity of the Rights Plan. The Chancery Court took the same approach (Op. 56). This view fails to take into account that the plan, and the difficulties it creates, are likely to deter many offers, even friendly offers, from being made in the first place. By vesting such pervasive control in the board, this plan will greatly increase the cost to tender offerors to the point where potential bidders will seek out other, more available, targets. Thus, many companies that otherwise would be bid for will have no offers made, and their shareholders will receive no premium.

The making of a tender offer involves great expense, the foregoing of other investment opportunities, and reputations of offerors and their advisers (Higgins VII 129-31). Thus, the offeror must believe it has a fairly strong chance of success. Yet the Chancery Court noted that the plan's "very complexity is designed to create uncertainty on the part of a potential acquiror"

27/ This would not, however, render it impossible for Household itself to solicit proxies. Under the plan, the rights are only rendered non-redeemable when a person becomes a "Beneficial Owner" of more than 20% of the stock, and either Household or the person makes a public announcement that the person has thereby become an "Acquiring Person," as that term is defined in the plan (PX 204 at 4). In the case of a proxy solicitation by Household, therefore, the rights would only become non-redeemable if Household publicly announced that it had become an "Acquiring Person"; Household could avoid this simply by not making such an announcement.

(Op. 7). As Higgins testified, this plan raises complications that bidders "may not care to attempt to solve or deal with" (Higgins VII 129). They will simply seek out a less problematic target. In fact, a recent study of anti-takeover charter amendments, all far less potent than Household's Rights Plan, concluded that even such weaker defensive devices have a "significant" effect in deterring offers from being made, reducing the incidence of such offers by at least 26%. Investor Responsibility Research Center, Inc., The Impact of Antitakeover Charter Amendments on Contests for Corporate Control 7-8 (1985). 28/ The effect of this plan in deterring offers could be expected to be much more significant.

More importantly, however, even if the plan would not deter all offers from being made, the defendants' wait and see approach does not allow shareholders to consider hostile offers, allow them to wage proxy contests, or return to them the power to oust management. It merely suggests that Household's present board may, in certain circumstances, approve an offer. Thus, Household's chairman testified that if an offeror made a 95% minimum conditioned offer, and 80% of the shareholders tendered, Household would redeem the rights (Clark VI 82-83). Even this concession means that 51%, or perhaps even 75%, of the shareholders could tender their shares to an offeror, and the board might still refuse to allow the offer to go forward. Of course, the

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28/ This finding is consistent with empirical evidence that shows that adoption of the Williams Act and state takeover statutes, laws which add to the costs of takeovers, reduced the number of takeover bids that were subsequently made. See Jarrell & Bradley, The Economic Effects of Federal and State Regulations of Cash Tender Offers, XXIII J. L. & Econ. 371, 398-403 (1980).

plan itself offers no guarantee to shareholders whether, and under what conditions, management would let a tender offer go forward. 29/

The interpositioning of management as the sole authority for determining whether a tender offer should go forward is not a substitute for a vigorous "market approach" in which the shareholders decide. As discussed above, the consistent view of Congress and of the Commission has been that the decision whether to accept or reject tender offers should be left, after full disclosure by management and bidders, to the shareholders. The Rights Plan would undercut the process contemplated by the Williams Act by giving the board a "plenary negotiation role" on behalf of the shareholders (Op. 56). Such a scheme, in our view, renders the Rights Plan inherently contrary to the shareholders' interests. It is our view that this plan is not justified and should not be sustained.

29/ We note that at a recent public forum, two of the five members of the Commission expressed the view that Household's plan would not allow a board to reject a fair offer for the company, and thus do not believe it tremendously enhances management's power to block tender offers. See 17 Sec. Reg. & L. Rep. (BNA) 400 (Mar. 8, 1985).

CONCLUSION

For the foregoing reasons, the judgment of the Chancery Court should be reversed.

Respectfully submitted,

JOSEPH J. FARNAN, JR.
United States Attorney
BY: SUE L. ROBINSON
Assistant United States Attorney

DANIEL L. GOELZER
General Counsel

JACOB H. STILLMAN
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Securities and Exchange Commission
Washington, D.C. 20549

Of Counsel
PAUL GONSON
Solicitor

March 19, 1985

Senator PROXMIRE. Mr. Chairman, I am going to ask a rather long question. I hope I don't run over my time. I realize that time is rapidly passing by.

FAVOR BIDDERS OVER TARGETS

But let me ask you this: I wonder how you would respond to criticism of the business community and others, that the administration and the Securities and Exchange Commission currently favor bidders over targets and fail to take into consideration the views of others.

Now I'd like you, before you answer that question, I'd like to ask you to consider the views of Professer Lowenstein, who testified here yesterday, and he said this:

> The argument that takeovers are systematically beneficial to the economy rests on several myths. A myth may be true or untrue, but the myths that have been energetically perpetuated, these myths are, false myth, No. 1, there is systematic scientific evidence that takeovers produce real gains in productivity and social welfare.

But that's a myth, it's untrue.

> No. 2 myth, this evidence is not only scientific, but essentially unambiguous and the Nation's scholars are in substantial agreement on the matter.

He said that's also false.

> No. 3, the best way to conduct a tender offer is to permit it to close quickly, as if it were a fire sale, thus favoring the initial bidder and restricting the opportunity for either a competitive auction or a measured response by the target.

That's myth.

> Myth 4, the tender offer process is an essential element of the necessary discipline for corporate managers. Without it, they would have too much freedom to manage the business for their personal ends.

That's another false one.

> The fifth false myth, since the shareholders are betting their own money, they can be relied on to protect not only their own interests but society's as well and do so better than those who might regulate the process.

He went on to say this:

> To begin with, the scholars are not in agreement. The 1985 Annual Report of the Council of Economic Advisers and Professor Jensen, for example, writing in the Harvard Business Review, both state that the scientific studies and scholarly analyses support the argument that takeover bids are beneficial. Those who disagree are painted as part villain and part fool, principally corporate managers trying to save their skins. In fact, a disagreement with Jensen and the Council of Economic Advisers comes not just from the executives and other players on the field, but from the scholars in the stands, scholars such as Tobin, Hayes, Law, Herman, Mueller, Scherer, and others, who have made known their concern. Ignoring their disagreement will not make it go away.

So my question to you is, what is your response to criticism from the business community that your agency favors bidders over targets and fails to take into consideration the views of others?

Mr. SHAD. I think what the SEC has been doing is trying to administer the laws that are on the books as effectively as they can, basically, the Williams Act in this area. It was stated repeatedly in the course of the hearings and the congressional reports on the Williams Act that the intention was not to tip the balance, but rather to make sure that there was adequate time and information for shareholders to make decisions.

We have made minor adjustments under the Williams Act provisions to extend the time. We have no evidence that the 20-business day minimum period for a tender offer does not afford shareholders adequate time and opportunity to make these decisions. We find that in the most criticized area, two-tier tender offers, 87 percent of the shareholders participate in the first tier. Now 13 percent may be people who never get the word anyway or foreign investors, limited partnership trusts, people who don't have the option to vote one way or another, and a whole variety of others.

So that it would appear that of the successful tender offers for less than all the shares, for over 51 percent of the shares, shareholders do have the time and opportunity to make an investment decision. We have also opposed the *Delaware* decision, and I view that type of poison pill as a total disenfranchisement of the shareholder. That's why I oppose it. I think that some of these activities, defensive tactics, in fact, remove investors from any participation in the decision process. I have a real problem with that. I think that people that risk their money in equity, the lowest tier of the capitalization of a company should have some voice in, and opportunity to make decisions.

I would be very pleased to take Mr. Lowenstein's specific points, if you wanted me to do so.

Senator PROXMIRE. Fine.

My time is up, Mr. Chairman.

Mr. Chairman, I'd appreciate it if Chairman Shad could ask the specific points and also give me whatever else we'd like to add on the allegation that your agency favors bidders over targets.

Mr. SHAD. Yes, sir.

Senator PROXMIRE. Thank you.

[The following information was subsequently submitted for the record:]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

June 11, 1985

Senator William Proxmire
Dirksen Senate Office Building
Room SD-530
Washington, D.C. 20510

Dear Senator Proxmire:

At the April 4, 1985 Subcommittee on Securities hearing on corporate takeovers, you requested that the Commission provide, for the record, (i) an analysis of the five "myths" propounded by Professor Lowenstein in his April 3, 1985 testimony before the Subcommittee; and (ii) a response to the allegation that the Commission favors bidders over targets in takeover contests.

Attached is a memorandum from the Office of the General Counsel reflecting the current status of your inquiry. The staff is continuing to work on your request and we anticipate that you will receive a detailed response by June 28, 1985.

Please contact Cecile Srodes of the Office of Legislative Affairs (272-2500) if you have any questions.

Sincerely,

John S.R. Shad

cc: Senator Alfonse M. D'Amato
Chairman, Senate Subcommittee
on Securities

50-673 O—85——10

MEMORANDUM

June 7, 1985

TO: Chairman Shad

FROM: Office of the General Counsel D Goelzer

RE: Items Requested for the Record at April 4, 1985 Hearing on Tender Offers Before Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs

During your April 4, 1985 testimony before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, Senator Proxmire requested that the Commission provide, for the record, (i) an analysis of the five "myths" propounded by Professor Lowenstein in his April 3, 1985 testimony before the Subcommittee; and (ii) a response to the charge that the Commission favors bidders over targets in takeover contests.

Both Professor Lowenstein's testimony and the allegation that the Commission is pro-bidder in the takeover area raise serious and complex questions about the effects of tender offers and about the Commission's regulatory responsibilities. We are currently engaged in a careful study of these issues, including a review of the testimony of Professor Lowenstein and other witnesses before the Subcommittee and an analysis of the Commission's role in the tender offer process.

After completion of this review, we will prepare a detailed memorandum discussing these issues. We expect that a response to Senator Proxmire can be provided by June 28, 1985.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

September 16, 1985

The Honorable William Proxmire
Committee on Banking, Housing,
and Urban Affairs
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Proxmire:

During my April 4, 1985, testimony before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, you requested an analysis, for the record, of the five "myths" propounded by Louis Lowenstein, a Professor of Law at Columbia University, in his April 3, 1985 testimony before the same Subcommittee. You also requested a response, for the record, to the allegation that the Commission favors bidders over targets.

Enclosed is a staff report, prepared by the Office of the General Counsel, analyzing the points raised by Professor Lowenstein and the Commission's role in takeover contests. Attached to this staff report is the Commission's response to Congressman Timothy Wirth's letter of January 25, 1985, which requested the Commission's views on a variety of issues concerning tender offers, including issues related to those raised by Professor Lowenstein.

Sincerely,

John S.R. Shad

Enclosure

Securities and Exchange Commission Staff Report in Response to Senator Proxmire's Requests for the Record At April 4, 1985 Hearing on Tender Offers, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs

September 3, 1985

I. Introduction

During April 4, 1985, testimony before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Senator Proxmire requested an analysis, for the record, of the five "myths" propounded by Louis Lowenstein, a Professor of Law at Columbia University, in his April 3, 1985 testimony before the same Subcommittee. Senator Proxmire also requested a response, for the record, to the allegation that the Commission favors bidders over targets.

Set forth below is an analysis of the points raised by Professor Lowenstein and a discussion of the Commission's neutral role in takeover contests. Attached to this staff report is the Commission's response to Congressman Timothy Wirth's letter of January 25, 1985. Congressman Wirth's letter requested the Commission's views on a variety of issues concerning tender offers, including issues related to those raised by Professor Lowenstein. This staff report is cross-referenced to particular questions in the attached response to Congressman Wirth.

II. Discussion

(a) Analysis of Professor Lowenstein's Myths

In his April 3, 1985 testimony, Professor Lowenstein pointed

to five "myths" ostensibly used by those contending that takeovers are beneficial to the U.S. economy. Before discussing each myth, a few general observations should be noted. First, the Commission is continuing to study takeover practices, many of which are undergoing rapid evolution. The debate on takeovers has often been steeped in rhetoric. Empirical data are, however, only beginning to emerge. To the extent Professor Lowenstein's comments constitute a call for further empirical research, we agree with that objective.

Professor Lowenstein's testimony highlights the existence of divergent views on the effects of takeovers. The five myths must be viewed as somewhat of an artificial creation. They are generally drafted in a manner that suggests only one possible conclusion. */ Indeed, the myths are phrased in a way that may obscure a number of other issues relevant to the debate on takeovers. Moreover, in disparaging the myths, Professor Lowenstein does not prove their converse -- that takeovers are harmful to the national economy.

This memorandum comments briefly on each of Professor Lowenstein's assertions and raises some additional issues relating to the myths.

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*/ Professor Lowenstein favors substantial additional regulation of takeovers. See Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 Colum. L. Rev. 249 (1983) (hereafter "Lowenstein").

Myth #1: There is systematic, scientific evidence that takeovers produce real gains in productivity and social welfare. */

In light of the Commission's responsibility to protect investors and further the efficiency of the nation's capital markets, the Commission has attempted to accumulate empirical data concerning takeovers. In attempting to quantify the premiums received in takeover contests, the Commission's Office of the Chief Economist has found that, from 1981 to 1984, average premiums of 53.4% above the prior market price were paid to target's shareholders. **/ Studies reviewed by the Commission's Advisory Committee on Tender Offers ("Advisory Committee") reached results consistent with this finding. ***/

Proponents of the benefits of takeovers also argue that they produce synergistic benefits, economies of scale, cost savings and transfers of technology and enable bidders to acquire efficiently complementary products that enhance market

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*/ See Securities and Exchange Commission Response to Congressman Wirth's letter of January 25, 1985 Concerning Tender Offers, August 22, 1985 (hereafter "SEC Response"), Part I, Questions 1, 2, 3 and 9.

**/ See The Economics of Any-or-All, Partial and Two-tier Tender Offers, Office of the Chief Economist, Securities and Exchange Commission, at Table 4a (April 19, 1985), attached to the SEC Response as Exhibit A.

***/ The studies examined by the Advisory Committee indicate that during the period in which a tender offer is considered the target company's shares rise an average of 30%, while the bidder's shares increase an average of 3-4%. Report of Recommendations, Advisory Committee on Tender Offers at 7, n. 6. (July 8, 1983) (hereafter "Report").

share and increase profitability. */ The Commission has not conducted extensive empirical research on the effects of takeovers on productivity.

Despite the benefits of takeovers, areas of concern obviously exist. For example, opponents of takeovers argue that leveraged buyouts **/ may burden companies with substantial debt. The net effect of a leveraged buyout is to retire equity and replace it with debt. To service the debt, the company must divert a significant portion of its cash flow from such productive purposes as capital investment and research and development. Moreover, because these buyouts generally involve floating rate debt, interest rate fluctuations have a magnified impact on the resulting highly leveraged companies. In the

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*/ For example, it was reported that one of the principal motivations behind General Motor Corporation's recent decision to acquire Hughes Aircraft Co. for an estimated $5 billion was the desire to obtain advanced technology that can be used in automobile manufacturing. See "GM's Winning Offer for Hughes May Set Heavy Industry Trend," Wall St. J. p.1 (June 6, 1985).

**/ Leveraged buyouts generally involve the purchase of a company or a subsidiary by a small group of investors and/or management with proceeds of loans collateralized by the assets of the company. Once control is acquired, the company is usually taken private. Leveraged buyouts typically involve a higher proportion of debt and smaller amounts of equity than ordinary mergers or tender offers.

The use of leveraged buyouts has increased dramatically in recent years. By some accounts, leveraged buyouts increased from 20% of all acquistions in 1982 to 50% in 1983. See "Buyout Boom: Leveraged Purchases of Firms Keep Gaining Despite Rising Risks," Wall St. J. p. 1 (Dec. 29, 1983). See generally Statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (April 4, 1985) (hereafter "Martin Statement").

event of an economic downturn, the number of bankruptcies among these companies may increase. */

Leveraged buyouts and mergers may also have short term impacts on credit markets. Chairman Volcker of the Board of Governors of the Federal Reserve System has noted that the changes in financial flows associated with mergers may have a measurable short-term impact on the monetary and credit aggregates, especially when the volume of merger activity is large. **/ Chairman Volcker has emphasized, however, that merger activity "should not generate significant macroeconomic effects." ***/ Also, Preston Martin recently testified that merger and acquisition transactions "should not generate lasting reductions in the amounts of financial resources available to other borrowers." ****/ Consistent with the statements of Chairman Volcker and Vice-Chairman Martin, the Advisory Committee found that no material distortion in the credit markets results from changes in corporate control. *****/

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*/ The Federal Reserve Board is monitoring this situation and has issued specific guidelines for examiners to follow in evaluating highly leveraged loans. See Martin Statement at 6-7.

**/ Letter from Paul Volcker, Chairman, Board of Governors of the Federal Reserve System, to Congressman Timothy Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (May 30, 1984).

***/ Id.

****/ Martin Statement at 4.

*****/ Report at 14.

Concerns have also been expressed about shareholder disenfranchisement through antitakeover amendments and changes in listing standards. */ For example, the NYSE Subcommittee on Shareholder Participation and Qualitative Listing Standards has proposed that the NYSE amend its rules to permit the listing of common stock that has only limited voting rights. Some have criticized the proposal because of its potential effects on shareholder voting rights. **/ Legislation has been introduced to restrict the trading of nonvoting shares and shares carrying disproportionate voting rights. ***/

Opponents of hostile takeovers contend that takeovers cause management to focus too extensively on short-term objectives. ****/ They also note that, on average, targets underperform the market as a whole in the period preceding a takeover. *****/ However,

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*/ See, e.g., Statement of Arthur Levitt, Chairman, American Stock Exchange, Inc, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (May 22, 1985).

**/ See, e.g., "Don't Bend the Big Board's Rules," Fortune (March 18, 1985).

***/ See S. 1314 and H.R. 2783, introduced on June 18, 1985.

****/ See Statement of Professor F. M. Scherer, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, at 5-7 (March 12, 1985).

*****/ This evidence is generally based on studies of stock prices. See, e.g., Easterbrook & Fishel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1165-74 (1981) (hereafter "Easterbrook & Fishel"). Some have challenged the conclusion that targets underperform the market. See, e.g., Lowenstein at 268-306. They do so, however, not by challenging the results of the stock price studies directly, but by asserting that stock prices are not an accurate indicia of a company's value.

empirical evidence compiled by the Commission's Office of the Chief Economist does not support the assertion that fear of takeovers causes management to deemphasize long-term objectives. */

Myth #2: This evidence is not only scientific but essentially unambiguous, and the nation's scholars are in substantial agreement on the matter. **/

Professor Lowenstein correctly indicates that scholars do not all agree about the effects of takeovers. For example, while some studies show that stock prices of a bidder increase following successful tender offers, the evidence on bidder returns with respect to mergers is mixed. ***/

In July, 1983 the Tender Offer Advisory Committee, after reviewing available empirical data, ****/ concluded that takeovers are not beneficial or harmful per se, to the economy or securities markets generally, or to issuers or shareholders in

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*/ See Institutional Ownership, Tender Offers, and Long-term Investments Office of the Chief Economist, Securities and Exchange Commission, (April 19, 1985), attached to the SEC Response as Exhibit B. This study, examining 324 firms, disclosed that their average research and development expenditures rose from 1980 to 1983, a period during which institutional ownership also increased. The study showed that stock prices react favorably to announcements that companies are embarking on R&D projects. The study also shows that target firms spent a lower percentage of their revenue on R&D expenditures than firms that did not become targets. This evidence, while not conclusive, is counter to the argument that the market penalizes companies that invest in long-term projects.

**/ See SEC Response, Part I, Questions 1 and 2.

***/ See Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 Journal of Financial Economics 16, 22 (April 1983).

****/ Recent empirical data compiled by the Commission's Office of the Chief Economist is discussed in our response to Myth #1.

particular. */ The Committee did conclude, however, that takeovers were valid methods of capital allocation. As a result of these conclusions, the Advisory Committee recommended that any regulatory scheme neither promote nor deter takeovers. The Commission concurred in this conclusion. **/

Myth #3: The best way to conduct a tender offer is to permit it to close quickly, as if it were a fire sale, thus favoring the initial bidder and restricting the opportunity for either a competitive auction or a measured response by the target. ***/

The Commission has long recognized the benefits of a minimum offering period for tender offers. ****/ In determining the appropriate length of the minimum offering period, the Commission has been guided by two basic goals: (a) assuring that shareholders of target companies had sufficient time to receive and digest the offer and make an informed investment decision, and (b) carrying out the intent of Congress in adopting the Williams Act, by maintaining neutrality between bidders and target companies to the extent consistent with the protection of shareholders. *****/ To effectuate this neutral intent, any

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*/ Report at xvii.

**/ See Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications, Consumer Protection and Finance, at 7 (March 28, 1984).

***/ See SEC Response, Part II, pp. 65-68.

****/ The Williams Act itself does not contain an explicit minimum offering period. As a practical matter, the seven day withdrawal period in Section 14(d)(5) of the Securities Exchange Act and the 10-day proration period in Section 14(d)(6) served to establish federal minimum offering periods for 100% and partial offers.

*****/ H.R. Rep. No. 1711, 90th Cong., 2nd Sess. 4 (1968).

minimum offering period must neither be so short as to unduly favor bidders nor so long as to unduly favor targets.

The existing 20 business day minimum offering period embodied in Rule 14e-1 under the Securities Exchange Act both protects shareholders and preserves neutrality. The Commission adopted that minimum offering period after lengthy deliberation and extensive public comment and analysis. The Commission concluded that a 20 business (28 calendar) day minimum offering period provides adequate opportunity for informed investment decisions, and preserves the neutrality between bidder and target, thereby serving the purposes and policies of the Williams Act. */

At the present time, the evidence supports the Commission's conclusion that the current offering period provides adequate time for shareholders to receive, consider and act on tender offer proposals. An extension, on balance, would increase the costs of the tender offer process unnecessarily, deter tender

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*/ In 1976, the Commission proposed a 15 business day minimum offering period. In February 1979, the Commission proposed a 30 business day minimum offering period, to be extended for an additional 10 business days following a price increase or an increase in dealer soliciting fees. See Securities Exchange Act Rel. No. 15548 (Feb. 15, 1979), 44 Fed. Reg. 9956. The Commission solicited public comment on whether the 30 business day minimum offering period ought to be longer or shorter and, if so, what period should be adopted. In response to its 1979 release, the Commission received 105 letters of comment. These comments reflected divergent views on the question of the length of the minimum offering period and the Commission's authority to adopt such a rule. See Summary of Comments Relating to Proposal Tender Offer Rules and Schedule, Securities Exchange Act Rel. No. 15548, File No. S7-770.

offers, and could undermine the basic principle of neutrality underlying the Williams Act.

Myth #4: The tender offer process is an essential element of the necessary discipline for corporate managers. Without it they would have too much freedom to manage the business for their personal ends. */

Takeovers often involve a reallocation of resources to higher valued uses. **/ The fact that resources are reallocated does not, however, compel the conclusion that prior management was inefficient. Bidders may pursue companies with strong operating managements at least as often as they pursue companies that have been clearly mismanaged. ***/ Also, the cyclical nature of takeover activity tends to refute the notion that bidders carefully search through the economy to find badly managed potential targets. ****/

An examination of companies subject to takeover bids does indicate that target companies generally underperform the stock market in the period preceding a takeover, *****/ but the reasons

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*/ See SEC Response, Part I, Questions 1 and 2.

**/ See generally CEA Report, at 196-99.

***/ See Coffee, Regulating the Market For Corporate Control: A Critical Assessment of the Tender Offer's Role In Corporate Governance, 84 Colum. L. Rev. 1145, 1206-07 (June 1984) (hereafter "Coffee").

****/ Id. at 1207.

*****/ See Easterbrook & Fishel, supra, at 1165-74; see also Hayes & Taussig, Tactics of Cash Takeover Bids, 45 Harv. Bus. Rev. 135, 142 (March-April 1967).

for this are uncertain. */ The Commission's Advisory Committee on Tender Offers found that "while in certain cases takeovers have served as a discipline on inefficient management, in other cases there is little to suggest that inefficiency of target company management is a factor." **/

Myth #5: Since the shareholders are betting their own money, they can be relied on to protect not only their own interests but society's as well and to do better than those who might regulate the process. ***/

Society benefits from an unhampered and efficient capital market. In adopting the Williams Act, Congress sought to protect shareholders by providing them with adequate time and opportunity to make intelligent investment decisions. At the same time, Congress sought to minimize interference in the capital markets by favoring neither bidders nor targets.

This policy of neutrality essentially contemplates that the success or failure of a takeover attempt will be determined by adequately informed shareholders. Indeed, as discussed earlier, the Advisory Committee recently reaffirmed that takeovers were a valid method of capital allocation and that a competitive marketplace was the ultimate regulator.

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*/ For example, while the bidder may tend to select the best bargain available once a list of potential targets has been assembled, the bidder's search for targets may be limited to companies whose assets and organizational structure "fit" with the bidder's structure. See Coffee at 1214-15.

**/ See Report at 8-9.

***/ See SEC Response, Part I, Questions 1 and 2.

(b) Commission's Role in Takeover Contests */

At the April 4, 1985 hearing before the Senate Subcommittee on Securities, questions were raised about a perceived bias by the Commission against targets in takeover contests. The Commission has not and does not favor either party in a takeover contest. To do so would be inconsistent with its statutory mandate.

Consistent with the regulatory philosophy underlying the Securities Act of 1933 and the Securities Exchange Act of 1934, **/ the Williams Act was designed primarily to protect investors by providing adequate opportunity and information to make informed investment decisions about the merits of a tender offer. ***/ As Senator Williams explained, the Act was intended to fill a

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*/ See SEC Response, Introduction to Part I.

**/ See S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) ("The basic policy [of the 1933 Act] is that of informing the investor of the facts concerning securities to be offered"); Santa Fe Industries Inc. v. Green, 430 U.S. 462, 477 (1977) quoting from Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) ("The purpose of the 1934 Act [is] 'to substitute a philosophy of full disclosure for the philosophy of Caveat Emptor.").

***/ Prior legislative proposals to regulate tender offers were not neutral, but were designed to favor incumbent management. In 1965, Senator Williams introduced S. 2731. 89th Cong., 1st Sess. (1965). He explained that the bill was designed to prevent "industrial sabotage" by companies that turn "proud old companies" into "corporate shells." 111 Cong. Rec. 28256, 28257 (1965) (statement of Senator Williams).

"gap" in disclosure left by the other securities laws. */ The Williams Act was intended to promote a policy of neutrality, **/ which favored neither bidders nor targets in a tender offer and left the ultimate decision about the success or failure of a tender offer to shareholders.

Consistent with the policies underlying the Williams Act, the Commission has sought to administer the Williams Act in a neutral manner, neither facilitating nor obstructing tender offers. In this way, shareholders are ensured adequate opportunity and information to make informed investment decisions about whether to participate in a tender offer. The Commission remains sensitive to Congress' intent that both the bidder and the target have relatively equal opportunities to state their cases to the shareholders.

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*/ Hearings before the Subcommittee of the Senate Committee on Banking and Currently, 90th Cong., 1st Sess. 1 (March 21, 1967) (statement of Senator Williams) ("At present, however, some areas remain where full disclosure is necessary for investor protection but not required. The legislation before the Subcommittee today will close what I consider to be a significant gap in these last remaining areas.") (hereafter "Senate Hearings"); see also Senate Hearings at 15 (statement of Manuel F. Cohen, Chairman of the Securities and Exchange Commission) ("The Commission is of a view that the legislation here proposed will fill a gap, rather large gap, in the securities statutes").

**/ H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); accord, Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 29 (1977). As Chairman Cohen noted shortly after introduction of the Williams Act, "[w]e support the bill because we believe it provides a suitable framework for giving investors adequate material information without unduly hindering tender offers which may be beneficial to them." Remarks of Manuel F. Cohen, Chairman, Securities and Exchange Commission Before the Association of the Bar of the City of New York (April 4, 1967).

The Commission's review of tender offer materials is conducted by the Division of Corporation Finance through the staff comment process. In fulfilling its role as impartial referee, the staff is keenly aware of the impact its comments may have on tipping the balance in a takeover contest and issues comments only to the extent necessary to ensure investor protection. All tender offer disclosure material */ filed with the Commission is subject to review and comment whether the takeover is characterized as "friendly" or "hostile." During fiscal years 1983 and 1984, the staff reviewed each of the filings by bidders and all recommendation statements filed by management and others. The staff has continued this practice and has reviewed all filings by bidders and all recommendation statements filed by management and others in fiscal year 1985 to date.

In addition to the staff's review of tender offer materials, enforcement action is also an important part of the Commission's role in the tender offer process. The Commission will continue to take action against those who engage in takeover contests without compliance with the federal securities laws. **/

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*/ The Commission's third party tender offer regulations require the filing of two separate schedules of information for tender offers subject to Section 14(d) of the Securities Exchange Act of 1934. Schedule 14D-1 is the required schedule of information that must be filed by the bidder with the Commission as soon as practicable on the date the bidder commences its tender offer. Schedule 14D-9 is the disclosure statement required to be filed by the target company and certain other specified persons when making solicitation or recommendation statements with respect to certain tender offers.

**/ As an exhibit to the April 4, 1985 testimony, the Commission provided the Senate Subcommittee on Securities with a list of Commission enforcement actions commenced on or after July 1, 1981, relating to changes in corporate control. Also provided as an exhibit was a list of amicus briefs filed by the Commission on or after July 1, 1981, relating to changes in corporate control.

JB/iv-lrb

Securities and Exchange Commission
Response to Congressman Wirth s Letter
of January 25, 1985 Concerning Tender Offers

August 22, 1985

Introduction

This report has been prepared by the staff of the Securities and Exchange Commission in response to a letter to Chairman Shad, dated January 25, 1985, from Congressman Timothy Wirth, Chairman of the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce. Congressman Wirth's letter requested the Commission's views on a series of questions (i) raised in the House Report on the Tender Offer Reform Act of 1984 (the "1984 House Report"); */ and (ii) relating to H.R. 5693, the "Tender Offer Reform Act of 1984". The Commission's responses to these specific questions are set forth in Parts I and II below.

I. Questions Raised in 1984 House Report

In the 1984 House Report, the Committee on Energy and Commerce expressed its intention to address various fundamental questions relating to tender offer regulation, many of which it then set forth in specific questions which the Commission has been asked by Congressman Wirth to address.

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*/ H.R. Rep. No. 1028, 98th Cong., 2d Sess. (1984).

Taken together, the questions raised in the 1984 House Report implicate broad issues of public policy that transcend existing regulatory structures. Among these issues are whether it is necessary and appropriate to adopt federal legislation to discourage certain types of corporate financing, to promote certain types of investment choices, and to direct the allocation of investment capital to preferred objectives. Such issues have not traditionally been addressed through regulation under the federal securities laws.

A number of other questions raised in the 1984 House Report were considered when Congress enacted the Williams Act. Consistent with the regulatory philosophy underlying the Securities Act of 1933 and the Securities Exchange Act of 1934, */ the Williams Act was primarily designed to protect

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*/ See S. Rep. No. 47, 73d Cong., 1st Sess. (April 17, 1933); ("The basic policy [of the 1933 Act] is that of informing the investor of the facts concerning securities to be offered"); H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933). See also 78 Cong. Rec. 2931 (May 5, 1933) (statements by Congressman Wolverton) ("The theory upon which [the 1933 Act] has been drawn is to give the public complete information as to the security offered for sale, rather than a governmental approval of the security."); Santa Fe Industries Inc. v. Green, 430 U.S. 462, 477 (1977) quoting from Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) ("The purpose of the 1934 Act [is] 'to substitute a philosophy of full disclosure for the philosophy of caveat emptor.").

investors by providing substantive protections, as well as adequate opportunity and information to make informed investment decisions about the merits of a tender offer. */ As Senator Williams explained, the Act was intended to fill a "gap" in disclosure left by the other securities laws. **/ The Williams Act was intended to promote a policy of neutrality, which favored neither bidders nor targets in a tender offer, giving

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*/ Prior legislative proposals to regulate tender offers were not neutral, but were designed to favor incumbent management. In 1965, Senator Williams introduced S. 2731. 89th Cong., 1st Sess. (1965). He explained that the bill was designed to prevent "industrial sabotage" by companies that turn "proud old companies" into "corporate shells." 111 Cong. Rec. 28256, 28257 (1965) (statements of Senator Williams).

**/ Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S.510 Before the Subcommittee on Securities of the Senate Committee on Banking and Currency, 90th Cong., 1st Sess. 1 (March 21, 1967) (statement by Senator Williams) ("At present, however, some areas remain where full disclosure is necessary for investor protection but not required. The legislation before the Subcommittee today will close what I consider to be a significant gap in these last remaining areas.") (hereinafter cited as "Senate Hearings"); see also Senate Hearings at 42 (statement by Senator Kuchel) ("There still remains a significant gap within which those who would misuse the public trust and hide under a blanket of secrecy can continue to carelessly speculate with the credit and fate of the nation."); Senate Hearings at 15 (statement by Manuel F. Cohen, former Chairman of the Securi ties and Exchange Commission) ("The Commission is of a view that the legislation here proposed will fill a gap, a rather large gap, in the securities statutes").

both bidders and targets equal opportunities to state their case to shareholders. The ultimate decision about the success or failure of a tender offer was left to shareholders. */

In administering the Williams Act, the Commission has found, in general, that the statute has been sufficiently flexible to deal with novel and innovative tender offer practices. The Commission believes that the principles underlying its regulatory scheme remain sound.

Nevertheless, the Commission shares the concerns expressed in the 1984 House Report about recent developments in both bidder and target tactics. The Commission's 1984 legislative proposal addressed certain of these techniques. Since that time, the manner in which contests for control are fought has continued to evolve.

In some respects, market participants themselves have developed strategies to respond to what, last year, were perceived to be

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*/ H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968) (hereinafter cited as "1968 House Report"); S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967) (hereinafter cited as "1967 Senate Report"); accord, Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 29 (1977). As former Commission Chairman Cohen noted shortly after introduction of the proposed Williams Act, "[w]e support the bill because we believe it provides a suitable framework for giving investors adequate material information without unduly hindering tender offers which may be beneficial to them." Remarks of Manuel F. Cohen, Chairman, Securities and Exchange Commission, Before the Association of the Bar of the City of New York (April 4, 1967).

the most abusive tender offer practices. And new practices raising different questions have emerged. Whereas a year ago the focus of concern was perceived abuses by management of potential targets in responding to hostile takeover attempts, today there appears to be an equal focus on the actions of bidders and potential bidders.

These circumstances demonstrate the difficulty in identifying long-term fundamental problems that warrant legislative solutions. In light of the evolution in this area, the major provisions of the Commission's 1984 legislative proposal appeared to be no longer necessary or effective to address current practices.

The Commission has continued to develop an empirical base from which to evaluate perceptions of abuse and the efficacy of proposed solutions. The results of the staff's studies to date have confirmed that certain frequently attacked practices have declined and that certain harms said to result from other practices cannot be established. Set forth below are responses to the specific questions posed in the 1984 House Report.

1. How can we assess the basic question of the relative benefits or harm resulting from hostile takeovers?

2. What is the impact of hostile takeovers on individual companies and their shareholders?

Answer: Most analysis to date has focused on the impact of hostile takeovers on individual companies and their shareholders. As the number and size of hostile tender offers have increased, concerns have been expressed about their effects. */ Concerns have also been raised about shareholder disenfranchisement through antitakeover amendments and changes in listing standards, **/ excessive leveraging, ***/ and the costs involved in the reallocation of resources resulting from hostile takeovers, such as plant closings. ****/ Opponents

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*/ See, e.g., Statement of Felix Rohatyn, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (June 6, 1985).

**/ See, e.g., Statement of Arthur Levitt, Chairman, American Stock Exchange, Inc., Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (May 22, 1985).

***/ See 1984 House Report at 13; see also Statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (April 23, 1985.)

****/ See Statement of Andrew Sigler, Chairman and CEO of Champion International Corp., Representing the Business Roundtable, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (June 6, 1985). It should be noted that plant closings are not unique to hostile takeovers.

have stated that takeovers cause management to focus too extensively on short-term objectives. */

At the same time, others have argued that hostile takeovers are generally beneficial. Proponents contend that takeovers can provide a check on management, ensuring its accountability to shareholders. **/ Takeovers provide shareholders of target companies with a substantial premium for their shares, a premium that can be reinvested in productive investments. Moreover, takeovers can produce synergistic benefits, economies of scale, cost savings and transfers of technology. Takeovers, therefore, may in some cases reallocate resources to higher valued uses.

Little empirical data has been presented to support these various views. The Commission's Office of

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*/ See Statement of Professor F.M. Scherer, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (March 12, 1985).

**/ See Statement of Professor Michael Bradley, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (April 3, 1985).

the Chief Economist and others have studied certain aspects of the economic impact of takeovers, particularly with respect to their effects on management behavior and on the share prices of bidders and targets. The results of some of these studies are set forth below.

1. Stock Prices: Target Company. Available empirical evidence indicates that corporate takeovers generate statistically significant increases in the stock prices of target firms during the time period around the announcement of the offer. */ In attempting to quantify the premiums received in tender offers, the Commission's Office of the Chief Economist has found that, from 1981 to 1984, average premiums of 53.4% above the prior market price were paid to target's shareholders. **/

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*/ Michael C. Jensen and Richard S. Ruback, The Market for Corporate Control: The Scientific Evidence, 11 Journal of Financial Economics 9-14 (April 1983) (hereinafter cited as "Jensen and Ruback"). This paper extensively reviews much of the available scientific literature on the market for corporate control. This paper is discussed at greater length in the answer to Question 11.

**/ See The Economics of Any-or-All, Partial and Two-tier Tender Offers, Office of the Chief Economist, Securities and Exchange Commission (April 19, 1985). A copy of this study is attached as Exhibit A. Several other studies prepared by the Commission's Office of the Chief Economist are also attached as exhibits to this letter. The views expressed in these studies are those of the Office of the Chief Economist and do not necessarily reflect the views of the Commission.

In its Report, the Commission's Advisory Committee on Tender Offers discussed studies that attempted to quantify the impact of hostile tender offers in terms of share price movements. These studies indicate that during the period in "which a tender offer is considered the target company's shares rise an average of 30% while the bidder's shares increase an average of 3-4%." */

2. Stock Prices: Bidder Company. Some studies have shown that the market price of bidders' shares increase following successful tender offers. **/ With respect to mergers, however, the evidence on bidder returns is mixed, suggesting that overall "returns to bidders in mergers are approximately zero." ***/

Another study examined the returns to the shareholders of unsuccessful bidders. This study found that stockholders of the unsuccessful

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*/ Advisory Committee on Tender Offers-Report of Recommendations, at 7, n.6 (July 8, 1983).

**/ Jensen and Ruback at 16, 22. The studies discussed in this paper examined share price data over a varied range of time periods.

***/ Id.

bidding firm suffered a "significant wealth loss" */ in cases in which the target subsequently accepted a bid by another bidder.

3. Effects on Corporate Planning. Some attempt has been made to determine empirically whether rising institutional ownership or the threat of hostile tender offers induces corporate management to pursue short-term results, at the expense of research and development and other beneficial long-term projects.

A recent study by the Commission's Office of the Chief Economist, **/ examining 324 firms in a broad cross-section of industries that invest heavily in research and development ("R&D") projects, disclosed that their average R&D expenditures rose from 3.38% of sales in 1980 to 4.03% in

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*/ M. Bradley, A. Desai and E. Kim, The Rationale Behind Interfirm Tender Offers, 11 Journal of Financial Economics 183, 186 (April 1983). This portion of the study looked at whether the target companies in the sample were acquired within a five year period after the initial unsuccessful bid.

**/ Institutional Ownership, Tender Offers, and Long-Term Investments, Office of the Chief Economist, Securities and Exchange Commission (April 19, 1985). A copy of this study is attached as Exhibit B.

the study shows that the R&D-to-revenue ratio for target firms was less than one-half that of the industry control group in the year immediately preceding the tender offer. */ A lower ratio of R&D-to-revenue for target firms was also present in the three years preceding the takeover. **/

4. Anti-Takeover Amendments. A study by the Office of the Chief Economist has demonstrated a statistically significant decline in stock prices following the adoption of certain anti-takeover provisions. ***/ The study showed that the adoption of supermajority provisions caused a 4% decline in stock prices, relative to the market. ****/ The adoption of "poison pill" provisions caused a decline of 3% at the time of adoption, with larger losses accompanying the subsequent withdrawal of bids in several cases studied. *****/

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*/ Id. at 8-10.

**/ Id.

***/ See Exhibit C. The study, which examined share price reaction from 20 trading days before through 10 trading days after the announcement of a supermajority provision, is discussed at greater length in the Commission's response to Question 11.

****/ Supermajority provisions generally increase the percentage of shareholders necessary to approve mergers and similar transactions to as high as 80 to 90%.

*****/ See Exhibit D. This portion of the study examined share price effects based on the price 10 trading days before and 40 trading days after the announcement of the "poison pills." "Poison pills" are defined and discussed at greater length in the Commission's response to Question 11.

1983, a period during which institutional ownership in these 324 firms increased from an average of 30% to an average of 38%. */

According to the Office of the Chief Economist's study, stock prices react favorably to announcements that companies are embarking on R&D projects. The increase in the equity value of 62 firms making such announcements in 1973-1983, relative to the market, was 0.80% during the two days following the announcement. This evidence appears to be counter to the argument that the market penalizes companies that invest in long-term projects.

This study also suggests that investment in long-term projects such as R&D does not make a firm vulnerable to a takeover bid. If R&D investment did make firms more vulnerable to takeover bids, one would expect to find that target firms spent a higher percentage of their revenue on R&D than firms that did not become targets. In fact, however, this study disclosed that the R&D-to-revenue ratio for target firms was lower than that of firms that did not become targets. In particular,

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*/ See Exhibit B at 6-7.

The Commission's Office of the Chief Economist is also reviewing the effect on share prices of the creation of dual classes of voting stock, frequently called "A-B capitalization." An examination of five firms that created dual voting classes has shown large share price declines relative to the market (-6.26% to -20.9%) during the small period of time around their respective announcement dates.

5. Reallocation of Resources. Takeovers can involve a reallocation of resources to higher valued uses. */ The fact that resources are reallocated does not, however, necessarily compel the conclusion that prior management was inefficient, as some claim. **/ Bidders may pursue companies with strong operating managements at least as often as they pursue companies with weaker managements. ***/ Also, the cyclical nature of takeover activity may refute the notion that bidders

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*/ See generally 1985 Report of the President's Council of Economic Advisers, at 196-99.

**/ See, e.g., Thigpen, Cash Offers, Capital Market Discipline, and the 1968 Legislation Revisited, 49 Tenn. L. Rev. 1, 16 (1981).

***/ See Coffee, Regulating The Market For Corporate Control: A Critical Assessment of The Tender Offer's Role in Corporate Governance, 84 Colum. L. Rev. 1145, 1206-07 (June 1984) (hereinafter cited as "Coffee").

carefully search through the economy to find badly-managed potential targets. */ Rather, hostile takeovers may have a greater correlation to changes in the regulatory or structural environment of certain industries.

An examination of target companies does indicate that such companies generally under-perform the stock market in the period preceding a takeover, **/ but the reasons for this are unclear. ***/ The Commission's Advisory Committee on Tender Offers found that "while in certain cases takeovers have served as a discipline on inefficient management, in other cases there is little to suggest that inefficiency of target company management is a factor." ****/

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*/ Id. at 1207.

**/ See Easterbrook & Fishel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981). See also Hayes & Taussig, Tactics of Cash Takeover Bids, 45 Harv. Bus. Rev. 135, 142 (March-April 1967).

***/ For example, while the bidder may tend to select the best targets available once a list of potential targets has been assembled, the bidder's search for targets may be limited to companies whose assets and organizational structure "fit" with the bidder's structure. See Coffee at 1214-15.

****/ See Report of Recommendations of the Advisory Committee on Tender Offers at 8-9 (July 8, 1983).

3. What is the impact on the credit markets and on individual companies of the tremendous borrowings used to fund mergers and leveraged buyouts?

Answer: Leveraged buyouts generally involve the purchase of a company or one of its subsidiaries by management or a small group of investors with proceeds of loans collateralized by the assets of the company being acquired. Leveraged buyouts generally involve a higher proportion of debt and smaller amounts of equity than ordinary mergers or takeovers. The use of leveraged buyouts has increased substantially in recent years. */ Recent proposals by certain entities to acquire and merge with much larger companies have also contemplated substantial debt financing.

The recent increase in leveraged buyouts is not without potential risks to the soundness of individual companies. The net effect of a leveraged buyout of a company is that equity is retired and replaced by debt. To service the debt, the company may have to divert a significant portion

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*/ By some accounts, leveraged buyouts increased from 20% of all acquistions in 1982 to 50% in 1983. See Hill & Williams, Buy-out Boom: Leveraged Purchases of Firms Keep Gaining Despite Rising Risks, Wall St. J. Dec. 29, 1983, at 1, col. 6. In 1984, approximately $15 billion in equity was retired in leveraged buyout transactions. Statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (April 4, 1985) (hereinafter cited as "Martin Statement").

of its cash flow from productive purposes, such as capital investment and research and development. Moreover, because these buyouts generally involve floating rate debt, fluctuations in the prevailing interest rates can have a magnified impact on the resulting, highly-leveraged, entities. In the event of an economic downturn, the number of bankruptcies among these companies may increase. */

It appears that leveraged buyouts and mergers may have short term impacts on credit markets. Chairman Volcker of the Board of Governors of the Federal Reserve System has noted that the changes in financial flow associated with mergers may have a measurable short-term impact on the monetary and credit aggregates, especially when the volume of merger activity is large. **/ Chairman Volcker has emphasized, however, that merger activity "should not generate significant macroeconomic effects." ***/

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*/ The Federal Reserve is monitoring this situation and has issued specific guidelines for examiners to follow in evaluating highly leveraged loans. See Martin Statement.

**/ Letter from Paul Volcker, Chairman, Board of Governors of the Federal Reserve System, to Congressman Timothy Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce (May 30, 1984).

***/ Id.

As noted by Chairman Volcker, leveraged buyouts do not appear to have significant long term effects on credit markets. Vice Chairman Martin of the Board of Governors of the Federal Reserve System recently testified that merger and acquisition transactions "should not generate lasting reductions in the amount of financial resources available to other borrowers." */ Consistent with the statements of Chairman Volcker and Vice-Chairman Martin, the Tender Offer Advisory Committee found that no material distortion in the credit markets results from changes in corporate control. **/

4. What is the impact of the increasing presence of institutional investors in the securities markets?

Answer: The term institutional investors generally encompasses such diverse institutions as pension and retirement funds, investment companies such as mutual funds, insurance companies, trust fund foundations, educational endowments and savings banks. Many of these institutions, including pension plans, the fastest growing category of

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*/ Martin Statement at 4.

**/ Report of Recommendations of the Advisory Committee on Tender Offers at 14 (July 8, 1983).

institutions, manage funds on behalf of large numbers of individuals. Institutions that manage pension plans covered by the Equity Retirement Income Security Act ("ERISA") are subject to various fiduciary duties, including the requirement that plan assets be invested in a "prudent" fashion and for the "exclusive benefit" of participating employees.

Since the 1940's, ownership of outstanding equity securities by institutional investors has increased steadily, accounting today for approximately 45% of public stock ownership and 70% of the daily trading volume on the New York Stock Exchange. */

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*/ Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications, Consumer Protection and Finance at 1 (May 23, 1985). The growth in the holdings of institutional investors has occurred primarily in the post-war era. Between 1860 and 1922, holdings of institutional investors other than personal trust funds declined. Institutional Investor Study Report, H. Doc. No. 92-64, 92d Cong., 1st Sess. 58 (March 10, 1971) (hereinafter cited as "Institutional Investor Study"). By 1952, however, institutional ownership was between 19 and 24% of total stock outstanding, compared with 7% at the turn of the century. Id. at ix. The holdings of institutional investors began to undergo dramatic growth in the 1960's, as investment programs shifted away from government and private debt securities to equity securities. Securities Industry Study, Report of the Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess. 64 (1973).

In recognition of the growing importance of institutional investors, Congress in the late 1960's directed the Commission to study the role of institutions in the securities markets. */ In the resulting eight-volume study, the Commission analyzed the involvement of institutional investors in the takeover process and, among other things, concluded that institutions were "major forces in the facilitation" of changes of corporate control. **/

Congress also expanded the available information about the holdings of institutional investors by amending the Securities Exchange Act to require certain institutional investment managers to file reports with the Commission containing information

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*/ Pub. L. No. 90-438 (July 29, 1968). The study was intended to provide additional economic information about the "extent and nature of institutional participation in the securities market." S. Rep. No. 1237, 90th Cong., 2d Sess. 1 (June 17, 1968).

Even before authorization of this study, former Chairman Cohen noted the Commission's interest in institutional investors: "As you might imagine, this increased activity of institutional investors in the equity markets, combined with the steady increase in their overall holdings of equity securities, has not gone unnoticed by the Commission."

Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission, Before the American Pension Conference (May 28, 1968).

**/ Institutional Investor Study at 2843.

about their portfolios. */ Data from these reports reveals that institutional investors often own a majority of the outstanding shares of a publicly traded company. **/

The influence of institutional investors may continue to increase. A number of large state and local pension funds recently formed the Council of Institutional Investors. The Council has approximately 22 members whose collective assets under management exceed $100 billion. Jesse Unruh, California State Treasurer and a member of the Council of Institutional Investors, testified before Congress that the Council will

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*/ Section 13(f), 15 U.S.C. 78m(f). Section 13(f) requires institutional investment managers exercising investment discretion over accounts containing securities with an aggregate fair market value of $100 million to file reports required by the Commission.

**/ For example, as of December 31, 1984, institutional investors subject to the reporting requirements in Section 13(f) of the 1934 Act owned in excess of 60% of the outstanding shares of a large number of Fortune 500 companies. Among those companies with high institutional ownership were Phillip Morris, Inc. (60.6%), Citicorp (64.9%), McDonald's Corp. (61.1%), Motorola, Inc. (60.5%), Honeywell, Inc. (70.9%), Monsanto, Inc. (60.8%), Texas Instruments, Inc. (69.9%), K-Mart Corp. (70.7%), Cigna Corp. (68.3%) and G. D. Searle & Co. (68%). Because the filing requirements in Section 13(f) do not extend to institutional investment managers with asset accounts containing less than $100 million, these percentages may have understated the institutional ownership of the respective companies. See Spectrum 4: 13(f) Institutional Investors xvi (Dec. 31, 1984) (published by Computer Directions Advisors, Inc.).

encourage its members, in the exercise of their fiduciary duties, to participate actively when financial resolutions are presented to shareholders. */ Institutions often have the resources and market expertise to develop sophisticated investment strategies. These attributes place institutional investors in a position, if they so desire, to block charter amendments that make takeovers more difficult or to take other actions to prevent steps they believe would otherwise adversely affect the company. **/

The increased participation of institutional investors in the securities markets appears to have significant benefits. They appear to have contributed to the depth and liquidity of the equity markets. Their active interest in the management

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*/ See Statement of Jesse M. Unruh, California State Treasurer, Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary (April 24, 1985).

**/ A survey of 2500 institutional money managers indicated that these managers oppose certain anti-takeover charter amendments, such as supermajority provisions, by a ratio of three to one. See Blustein, Measures to Discourage Takeovers Stir Controversy at Annual Meeting, Wall St. J., April 18, 1983, at 29, col. 4. The study also showed that these managers favored some anti-takeover charter amendments such as fair price provisions. Id.

of the companies in which they invest may promote the informed exercise of shareholder voting.

Some opponents of hostile tender offers argue that institutional investors' clients judge their performance on a quarterly basis and that, as a result, institutional investors favor opportunities for short-term profits. This is said to encourage corporate management to pursue short-term results, at the expense of capital investment, research and development, and other long-term projects. Proponents of this view have not provided empirical evidence of this phenomenon. Findings made in a recent study by the Commission's Office of the Chief Economist failed to support this view. */

5. What is the impact of arbitrageurs in hostile takeover battles?

Answer: The term arbitrageur is commonly used to refer to any person both buying and selling an asset, such as a stock, bond or commodity, in two different markets at approximately the same time in order to take advantage of any price difference between the two

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*/ See Exhibit B, discussed supra.

markets. */ Such persons, who are likely to be sophisticated investors or market professionals, play an important role in the securities markets. Their willingness to put their money at risk enhances the liquidity of the securities markets, and arbitrage activity tends to improve market efficiency by correcting anomalies in price. **/ The term arbitrageur has also been used to refer to professional stock traders who buy the stock of companies that become the target of hostile

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*/ P. Wyckoff, Dictionary of Stock Market Terms 12-13 (1964) ("Arbitrage - The purchase of a security or commodity in one market and the almost simultaneous sale * * * of the same security or commodity in another market at a different price. The object is to profit from any price difference between the two markets."). See also L. Loss, Securities Regulation 1108, n.276 (1961) (hereinafter cited as "Loss").

Regulation T defines the term "'bonafide' arbitrage" to include "(a) a purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable for the purpose of taking advantage of a difference in prices in the two markets, or (b) a purchase of a security which is without restriction other than the payment of money, exchangeable or convertible within 90 calendar days of the purchase into a second security together with an offsetting sale of the second security at or about the same time, for the purpose of taking advantage of a concurrent disparity in the prices of the two securities." 12 C.F.R. 220.7.

**/ See Loss at 1108-09, n.276 ("Professional arbitrageurs, by buying in the lower market and selling in the higher, serve a legitimate economic function in thus bringing the prices in two markets together.").

takeovers, often tendering their shares to the bidder. */

In the context of hostile tender offers, arbitrageurs play a significant facilitating role. Arbitrageurs provide liquidity to the market and assume the risk that tender offers will be unsuccessful. If the probability of a bid's success increases or higher bids are received, the price will generally rise further, but if the target wards off the tender offer and succeeds in remaining independent, the price will generally fall. Shareholders who do not wish to assume this risk can sell their shares into the market which arbitrageurs help to create. **/ In partial tender offers, shareholders who sell into the market avoid the risk that they will receive only pro rata acceptance of the shares they tender.

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*/ Reiser, Corporate Takeovers: A Glossary of Terms and Tactics, Case & Comments 35 (Nov.-Dec. 1984).

**/ For a discussion of the benefits provided by arbitrageurs, see Johnson, Disclosure in Tender Offer Transactions: The Dice are Still Loaded, 42 Pitt. L. Rev. 1, 11 (1980); see also Remarks of Phillip A. Loomis, Jr., General Counsel, Securities and Exchange Commission, before the New York City Bar (April 14, 1967).

Arbitrageurs generally have the resources and specialized skills to gauge the probable outcome of tender offers, mergers, recapitalizations and other transactions. They have, however, on occasion suffered multi-million dollar losses. */ The keen competition among arbitrageurs appears to be reflected in higher market prices than would otherwise be available, to the benefit of all of the company's shareholders.

Two principal concerns have been raised about the role of arbitrageurs in hostile tender offers. It is argued that they lack any long-term interest in the companies in which they hold shares. There is also a perception that they enjoy unfair informational advantages that may facilitate improper insider trading activity. **/

It is not clear that the short-term ownership of shares by arbitrageurs, as distinct from that of

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*/ One arbitrageur reportedly lost $80 million on one aborted takeover attempt. See Wall Street's Risk Takers Roll the Dice Again, U.S. News & World Report p. 60 (Feb. 18, 1985).

**/ See Testimony of Felix Rohatyn, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (June 6, 1985).

other investors, presents a particular regulatory or policy concern. The concern over arbitrage activities may be a reflection of more fundamental concerns about the perceived short-term orientation of professional investors, and perhaps others. Attempts to address such concerns through securities regulation would represent a major departure from the traditional objectives of the federal securities laws.

With respect to arbitrageurs' alleged informational advantages, the Securities Exchange Act, including the Williams Act and the tender offer rules thereunder, provide the Commission with authority to restrain insider trading violations by any person.

Commission Rule 14e-3 specifically establishes a disclose or abstain from trading rule for any person who is in possession of material information that relates to a tender offer by another person, if he knows or has reason to know the information is nonpublic and if the information was acquired, directly or indirectly, from the bidder or from the issuer which is the subject of the tender offer. Rule 14e-3 also establishes an anti-tipping

rule with respect to material, nonpublic information relating to a tender offer. */ Where there is evidence of a violation of these proscriptions by any entity or individual, including any arbitrageur, the Commission will continue to take appropriate enforcement action.

6. Should large, open-market purchases of the shares of public companies be conducted totally outside the tender offer process?

Answer: With the one exception discussed below, the Commission does not believe that additional legislation governing open market purchases is necessary at this time. The primary federal interests operating in the regulation of open market purchases are to assure adequate post-acquisition notice to investors of significant accumulations of equity securities and of their opportunity to participate in any open market purchase program, while at the same time preserving the free and open auction market in which open market purchases take place. **/ The Commission

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*/ Commission Rule 14e-3, 17 C.F.R. 240.14e-3; Securities Exchange Act Release No. 17120 (September 12, 1980).

**/ In creating the regulatory scheme embodied in the Williams Act, Congress expressly determined not to subject ordinary open market purchases to the regulatory provisions governing tender offers. See 113 Cong. Rec. 856 (1967) (remarks of Senator Williams).

believes that existing regulation of open market purchases serves these ends.

Open market purchases are subject to Section 13(d) of the Exchange Act, which provides that any person who acquires the beneficial ownership of more than five percent of the equity securities of a public company must file a statement within ten days after the acquisition of such interest describing, inter alia, the background of the purchaser, the purposes for the acquisition, and any plans or proposals for acquiring control of, merging with, or liquidating the issuer. */ By Congressional design, the initial filing under Section 13(d)(1) is a post-acquisition requirement, and Section 13(d)(1) does not prohibit further open market purchases by a person who has acquired more than five percent of a corporation's stock. **/

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*/ This statement is required to be sent to the issuer and the exchanges on which the security is traded, and to be filed with the Commission.

**/ Congress considered and rejected the imposition of more restrictive provisions, including a requirement for advance public announcement, with respect to these types of non-tender-offer purchases.

On May 20, 1985, the Commission voted to continue to support its 1984 proposal to close the ten-day filing window in current Section 13(d) of the Exchange Act. This proposal would, in a manner that does not involve pre-acquisition filing, more effectively accomplish the Congressional intent of alerting the issuer, the market and all investors to rapid accumlations of equity securities. */

In addition to regulation under Section 13(d), the Commission believes that third-party and issuer acquisition programs intended to, or reasonably likely to, pressure shareholders to sell their shares constitute tender offers subject to the same requirements under the Williams Act and the Commission's rules that are applicable

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*/ The Commission's proposal would permit it to require immediate public announcement of a triggering acquisition, to specify the time, after acquisition of a 5% interest, for filing a statement and to specify a length of time, not to exceed 2 business days after filing, during which additional purchases may be restricted. The legislation would not provide authority to impose a requirement of a pre-acquisition filing of the statement.

to any tender offers. */ This applies whether the purchases are made in the open market or in face-to-face dealings. **/

Issuer repurchase programs raising the concerns that the Williams Act was designed to address, e.g., undue pressure on shareholders to part with their shares, are subject to Rule 13e-4, the Commission's issuer tender offer rule. The rule acts to prohibit the issuer from repurchasing its

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*/ See, e.g., Securities Exchange Act Rel. No. 16385, 44 Fed. Reg. 70349 (Nov. 29, 1979) ("To say that purchases take place on the floor of a securities exchange * * * does not end the inquiry. The use of facilities of an exchange may be a mere formality to disguise what is otherwise in effect a tender offer * * *"); Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.), cert. denied, 419 U.S. 873 (1974); Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979), aff'd on other grounds, 682 F.2d 355 (2d Cir. 1982), cert. denied, 103 S. Ct. 1522 (1983). See also Securities Exchange Act Release No. 16385, 44 Fed. Reg. 70349 (Nov. 29, 1979) (proposing a definition of the term "tender offer"); Memorandum of the Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs Proposing Amendments to the Williams Act (Feb. 15, 1980) (proposing, inter alia, the adoption of amendments to the Williams Act based on the concept of a "statutory offer").

**/ See 1984 House Report at 12.

stock in the market absent certain disclosures. */

In SEC v. Carter Hawley Hale Stores, Inc., 587 F. Supp. 1248 (C.D. Cal. 1984), aff'd, Nos. 84-5897, 6001 (9th Cir. May 13, 1985), the Commission unsuccessfully alleged that an open market repurchase program initiated by Carter Hawley Hale in response to a hostile tender offer violated Rule 13e-4. The Commission argued that Carter Hawley Hale's repurchase program of approximately 50% of its outstanding shares in 7 trading days was itself a tender offer,

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*/ If a target company's managers wish to compete with an outstanding tender offer by making a tender offer for their company's own shares, Rule 13e-4 requires that they abide by essentially the same rules as the third party. Issuers must disclose certain material information, allow shareholders to withdraw tendered shares for a minimum of 10 business days following the commencement of the offer and for 7 business days following the commencement of a competing offer, and accept shares tendered during the first 10 business days of the offer on a pro rata basis if the offer is over-subscribed. 17 C.F.R. 240.13e-4(f). The Commission's rules require that issuers generally hold their tender offers open for 15 business days. Rule 13e-4(e), 17 C.F.R. 240.13e-4(f). However, in order to ensure that competing tender offers are conducted in accordance with the same rules, the Commission's rules require that the issuer hold its tender offer open for 20 business days if its offer is made in anticipation of or in response to a third-party's tender offer. Rule 14e-1(a), 17 C.F.R. 240.14e-1(a). See Securities Exchange Act Rel. No. 16384 44 Fed. Reg. 70326 (Nov. 29, 1979).

and that shareholders did not have an adequate opportunity to participate in the offer. The Ninth Circuit upheld the district court's conclusion that Carter Hawley Hale's open market purchase program was not a tender offer. However, the Commission continues to believe that open market purchase programs that exhibit the indicia of a tender offer are subject to regulation under the Williams Act and the rules thereunder, and will continue to take action against those who engage in tender offers without compliance with the federal securities laws.

7. What are the consequences of two-tier and partial tender offers?

Answer: Some have criticized two-tier and partial tender offers as "coercive" and suggested that such offers be prohibited or restricted. The principal argument advanced by those who believe two-tier offers are harmful has been that they coerce shareholders to accept the initial offer, because if the initial offer is successful, the remaining shareholders will receive a lower price for their shares in the second step. The same reasoning has been applied to partial offers, in which shareholders

may receive a lower price for their shares in subsequent offers or in subsequent open market sales.

The Commission, however, has not determined that partial and two-tier tender offers should be outlawed. Partial offers have long been an accepted practice that serves valid business purposes. Among other things, such acquisitions: (i) allow companies to invest in others, with less than 100% financial exposure; (ii) facilitate technological exchanges and relationships; (iii) permit proportional recognition of 20% or larger interests, under corporate equity accounting; (iv) facilitate venture capital, foreign and other direct investments; and (v) permit investors to become familiar with potential acquisitions, before deciding to increase their investment.

Restriction of partial bids would raise concerns about immunizing large issuers from tender offers. Moreover, there is little evidence that individual shareholders have had difficulty in participating in offers for less than all the shares.

In addition, partial and two-tier offers provide substantial premiums to shareholders. A study by

the Commission's Office of the Chief Economist shows that in 1981-84, the average blended premium for any-and-all offers was 59.6%, 54.5% for two-tier offers and 20% for partial offers. */

It is important to note that it would be difficult to regulate two-tier offers without also regulating partial offers. Because of such valid business purposes of partial offers as those identified above, such regulation could have significant economic consequences.

If the Congress were to prohibit two-tier offers, one effect could be that, rather than causing more bidders to make any-and-all bids, bidders would react to such a bar by resorting more frequently to partial offers. Shareholders as a result would be denied the greater values historically provided in two-tier offers.

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*/ See Exhibit A. See also Securities Exchange Act Rel. No. 21079 (June 21, 1984), 49 Fed. Reg. 26751 (Commission concept release on partial and two-tier bids). In response to a request from the Senate Banking Committee, the Commission provided members of that Committee, as well as members of the House Committee on Energy and Commerce, with a summary of the 18 comment letters received in response to this concept release. The comment letters expressed a range of views on the subject of two-tier bidding, partial bids and non-tender offer purchase programs.

In any case recent data indicates that the incidence of two-tier bidding has decreased since of the adoption of Rule 14d-8. */ That rule expands protections for shareholders by requiring unlimited pro rata acceptance of tendered shares throughout the offer.

FISCAL YEAR	TOTAL TENDER OFFERS	TWO-TIER BIDS **/	PARTIAL BIDS
1983	92	22	19
1984	121	15	19
1985 (as of May 20, 1985)	103	5	25

The steady reduction in the number of two-tier offers over the past three years indicates that any problem presented by two-tier offers is now minimal.

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*/ Securities Exchange Act Rel. No. 19336 (November 29, 1983), 44 Fed. Reg. 70326.

**/ For purposes of this chart, a two-tier bid involves an acquisition of all outstanding shares that is accomplished in two steps -- a partial tender offer followed by a merger -- whether or not different consideration is offered in the several steps. In the first step, the bidder uses a tender offer to buy enough shares to establish a controlling position in the target. Once control is established, the offeror will engage in a second step business combination, usually a merger, taking out the minority shareholders with a consideration, usually securities, frequently valued at a lower price than the original tender offer price. The second step merger and its consideration are disclosed in the tender offer materials.

8. What is the impact of our current tax structure on take-overs and leveraged buyouts? Does the current structure give too many incentives to "unproductive" acquisition activity, financed in part by Federal tax deductions?

Answer: The Commission has no special expertise in the tax area. It is clear, however, that the following tax provisions affect tender offers and leveraged buy-outs in a number of ways:

- the interest deduction on large amounts of debt;
- the ability to write-up assets to higher values, creating a higher tax basis;
- accelerated cost recovery under the Tax Reform Act of 1981;
- incentives in the tax code relating to employee benefits plans that enable management to repay certain indebtedness with pre-tax dollars and allow lenders to ESOPs to exclude from income 50% of the interest income received on loans used by the ESOPs to acquire employee securities;
- the dividend exclusion for corporations; and
- the excise tax on "golden parachutes."

These provisions may affect not only tender offers and leveraged buyouts, but also mergers and other business-combination transactions. Since these issues are matters primarily within the jurisdiction of other federal agencies, the Commission has taken no position with respect to the various incentives and disincentives built into the tax code.

9. Should the regulation of leveraged buyouts be changed to ensure that shareholders are treated fairly?

Answer: A leveraged buyout is simply one method by which management or third parties may acquire control of a company. Such buyouts are characterized both by heavy debt financing and use of the company's assets to collateralize the debt.

Leveraged buyouts per se are not regulated under the federal securities laws. Nonetheless, they may implicate a number of concerns addressed by the Williams Act. These include Commission regulation of those leveraged buyouts structured as going private transactions, as well as regulation of all leveraged buyouts that involve a tender offer as part of the transaction. Also, when a leveraged buyout involves a merger, compliance with the Commission's proxy rules will be required.

The Commission's proxy rules are set forth in Regulation 14A under the Securities Exchange Act of 1934. These rules make it unlawful for any person to furnish any communication to holders of a class of securities registered under Section 12 of the 1934 Act under circumstances reasonably calculated to result in the procurement, withholding

or revocation of a proxy without first furnishing them a proxy statement.

Schedule 14A under Regulation 14A sets forth the information required in proxy statements distributed pursuant to Regulation 14A. Schedule 14A requires that proxy statements include a description of all matters being proposed for shareholder action. The description required generally must include information regarding the reasons the matter is being proposed, the effect upon shareholders should the proposed matter be approved, and the vote required for approval. Any substantial interest of certain persons in the matter to be acted upon, including interests of the person(s) on whose behalf the solicitation is being made, must be described. Where the matters to be acted upon include the election of directors, Schedule 14A requires the disclosure of certain information about the background and experience of the nominees. Where the matters proposed for action involve the authorization or issuance of securities, the modification or exchange of securities, or a merger, consolidation, acquisition or similar matter, Schedule 14A generally requires that a proxy statement include

financial statements and a discussion and analysis by management of the issuer's financial condition and results of operations.

Pursuant to Section 13(e) the Commission adopted Rule 13e-3, which regulates "going private" transactions. */ Consistent with the general philosophy of the Williams Act, Rule 13e-3 requires issuers to disclose information necessary for shareholders to make informed decisions. Rule 13e-3 implements this policy by requiring issuers to reveal: (1) the purpose, alternatives, reasons and effects of the transaction; (2) the benefits and detriments of the transaction on the company, affiliates and shareholders; (3) a statement as to whether management reasonably believes that the going private transaction is fair or unfair to shareholders; and (4) a statement as to whether

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*/ Generally, the phenomenon of "going private" involves a transaction in which controlling shareholders eliminate remaining minority shareholders. See Securities Exchange Rel. No. 17719 (April 13, 1981) (going private occurs when the transaction "would result in one or more classes of equity securities of the issuer no longer having attributes of public ownership"). Often, the number of shareholders declines sufficiently to obviate the company's obligation to make the periodic filings required under the Securities Exchange Act.

management has received any report, appraisal or opinion from an investment banker or other expert with respect to the terms of the transaction. Any such report, appraisal or opinion must be described and made available to shareholders.

If a leveraged buyout is structured as a tender offer, Commission rules require third party bidders to file a Schedule 14D-1. */ A Schedule 14D-1 must include information relating to the subject security and the subject company, information concerning the identity and background of the persons filing, source and amount of funds used or to be used for the acquisition, the securities of the subject company acquired and contractual and other arrangements and under standings relating to the securities being acquired. The Schedule 14D-1 must also disclose the exact number of shares being sought; the consideration being offered; the identity of the principal market in which the securities are traded; and

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*/ Rule 13e-4 promulgated under the Williams Act imposes similar disclosure requirements in connection with issuer tender offers. The detailed requirements of Rule 13e-4 are discussed in the Commission's response to Question 6, supra.

for the immediately preceding three full years, must describe any transactions, including negotiations, between the bidder and the subject company. The Schedule must also disclose the purpose of the tender offer and the plans of the bidder relating to changes in management, transfer of assets, and extraordinary corporate action such as a merger or liquidation. If the bidder is not a natural person and its financial condition is material to the investment decision being presented, appropriate financial information relating to the bidder must be included.

The Commission's role in leveraged buyouts ensures conformity with the full disclosure requirements of the Williams Act. The Commission does not assess the "fairness" of transactions, */ but rather requires accurate and complete disclosure that will enable investors to decide for themselves whether or not a transaction is fair. The fairness of such transactions may be subject to

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*/ In 1975, the Commission proposed a rule that would have required issuers "going private" to pay "fair value" for shares, as determined in good faith. Securities Exchange Act Rel. No. 11231 (Feb. 6, 1975) (proposing Rule 13e-3A). The Commission did not, however, adopt the proposed rule. See Securities Exchange Act Rel. No. 14183 (Nov. 17, 1977).

state fiduciary standards. A few states have adopted statutes designed to ensure fair treatment of shareholders in going private transactions. */ Most states, however, rely on fiduciary duties and the business judgment rule in assessing such transactions. **/

In March 1984, the Commission testified that it

> agrees with the Advisory Committee's recognition of the general preeminence of state corporate law with respect to the internal affairs of a corporation. However, in the application of the business judgment rule in a change of control context, the Commission believes that shareholders would be better served if the courts gave greater recognition to potential conflicts of interest between management and shareholders. ***/

However, the Commission has not determined that there is a need for federal preemption of state corporate law in the governance of going private transactions.

10. What is the proper relationship between State and Federal law in regulating the takeover process?

Answer: The relationship between state and federal regulation of the tender offer process presents

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*/ See, e.g., Wis. Admin. Code § 6.05 (1985).

**/ See generally Lyons, Fairness in Freezout Transactions: Observations on Coping with Going Private Problems, 69 Ky. L.J. 77 (1980).

***/ Statement of John S.R. Shad, Chairman, Securities and Exchange Commission, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, at 10-11 (March 28, 1984).

Constitutional questions. Under the Supremacy and Commerce Clauses of the Constitution, the role of states in this area is limited. As has often been observed, "[t]ender offers are a nationwide phenomenon." */

The Commerce Clause was expressly designed to create a nationwide "area of trade free from interference by the states * * *." **/ Untoward interference by states in the tender offer process, therefore, will constitute an impermissible burden on interstate commerce and violate the Commerce Clause. In Edgar v. MITE Corp., ***/ the Supreme Court struck down the Illinois anti-takeover statute, holding that it violated the Commerce Clause because it imposed "excessive" burdens on interstate commerce. Following that decision, several state statutes have been invalidated on Commerce Clause grounds. ****/

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*/ Mesa Petroleum Co. v. Cities Service Co., 715 F.2d 1425, 1429 (10th Cir. 1983)

**/ Freeman v. Hewitt, 329 U.S. 249, 252 (1946).

***/ 457 U.S. 624, 643-44 (1982). Five Justices joined in the Court's opinion, authored by Justice White. Three Justices dissented on the ground that the case was moot.

****/ See, e.g., Mesa Petroleum Co. v. Cities Service Co., 715 F.2d 1425, 1429 (10th Cir. 1983); Martin-Marietta Corp. v. Bendix Corp., 690 F.2d 558, 565 (6th Cir. 1982).

A state anti-takeover statute violates the Supremacy Clause if it "stands as an obstacle to the accomplishment and execution of the full purposes" of the Williams Act. */ A state statute will also be preempted under the Supremacy Clause whenever "compliance with both federal and state regulations is a physical impossibility." **/ A number of state anti-takeover provisions have been invalidated under the Supremacy Clause. ***/

The Commission's Tender Offer Advisory Committee considered the appropriate relationship between state and federal law in takeover regulation. Portions of the Advisory Committee Report expressed approval of state corporate law. For example, Recommendation 9(b) stated that "[e]xcept to the extent necessary to eliminate abuses or interference with the intended functions of federal takeover

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*/ See Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

**/ See Flordia Lime & Avacado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963).

***/ See, e.g., Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978), rev'd on venue grounds sub nom, Leroy v. Great Western Corp., 443 U.S. 173 (1979); Kennecott Corp. v. Smith, 637 F.2d 181 (3d Cir. 1980); Crane Co. v. Lam, 509 F. Supp. 782 (E.D. Pa. 1981); Canadian Pacific Enterprises (U.S.), Inc. v. Krouse, 506 F. Supp. 1192 (S.D. Ohio 1981). See also Edgar v. MITE, 457 U.S. at 630-40 (portion of Justice White's opinion in which Chief Justice Burger and Justice Blackmun concurred).

regulation, federal takeover regulation should not preempt or override state corporation law. Essentially the business judgment rule should continue to govern most such activity."

Nevertheless, the recommendations of the Advisory Committee reflect a rejection of state law obstacles to national tender offers. The Committee concluded in Recommendation 4 that "[r]egulation of takeovers should recognize that such transactions take place in a national securities market." Moreover, Recommendation 34 provided:

> State laws and regulations, regardless of their form, that restrict the ability of a company to make a tender offer should not be permitted because they constitute an undue burden on interstate comerce. Included in this category should be statutes that prohibit completion of a tender offer without target company shareholder approval and broad polilcy legislation written so as to impair the ability to transfer corporate control in a manner and time frame consistent with the federal tender offer process.

Recommendation 34 recognized only two exceptions to this broad federal preemption of state takeover statutes -- "local companies and regulated industries." */

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*/ The Advisory Committee indicated in Recommendation 9 that the permissible scope of state tender offer regulation extends only to "local companies" and "public interest

(footnote continued)

In testimony before Chairman Wirth's Telecommunications Subcommittee on March 28, 1984, the Commission expressed general agreement with these recommendations. The Commission's testimony was based on its continuing belief that the regulation of takeovers should be federal, since these transactions take place in the national securities market, and regulation by the states must neither unduly burden interstate commerce nor conflict with the Williams Act. */ The Commission expressed its intent to continue to implement its policy on state takeover statutes through amicus curiae participation in private litigation to challenge state statutes which impede the operation of the

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__/ (footnote continued)

businesses" such as banks, utilities, and insurance companies. Even in those areas, Recommendation 9 provided that state regulation should only be permitted if it is justified in relation to the overall objectives of the industry, does not conflict with procedural provisions of federal tender offer regulations, and relates to a significant portion of the issuer's business.

*/ One economist concluded that "state statutes increased the likelihood that tender offers would fail, and provided a measurable and statistically significant deterrence to tender offer activity." Smiley, The Effect of State Securities Statutes on Tender Offer Activity, 19 Econ. Inquiry 426, 433 (1981).

federal tender offer process. **/

11. What is the impact of the increasing number of companies adopting charter and by-law amendments to make corporate tender offers more difficult?

Answer: From 1979 through 1984, shareholders of over 450 companies approved supermajority, fair price and other charter and by-law amendments that make it more difficult for changes in corporate control to take place. In fiscal 1985, as of June 21, 1985, the Commission has received definitive proxy statements containing such anti-takeover proposals for 305 companies.

The ultimate impact of such amendments may vary according to the particular type of amendment adopted. Supermajority provisions typically permit the holders of 20% of the shares to block a statutory merger. Fair price provisions, which have accounted for over 80% of proposed antitakeover amendments in the last two years, require bidders to pay all shareholders the highest price paid for any shares purchased during a specified period of time. Typically, the adoption of

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**/ The Commission proposed legislation in 1980 to specifically preempt state laws governing tender offers. See Tender Offer Report at 123. Because of the success of the Commission's amicus curiae program in this area, the Commission does not believe that such legislation is now necessary.

supermajority or fair price provisions requires shareholder approval.

Poison pills may become one of the most effective defenses to tender offers devised to date. A poison pill is a stock, warrant, or right issued by a company to its shareholders. Generally, a poison pill may be exercised if a tender offer for the company is made, a specified percentage of the company's stock is acquired or a group of investors holding a specified amount of the company's stock is formed. In the event of a merger or other combination, poison pills typically permit target company shareholders to purchase shares in the acquiring company at a substantial discount from the market or to acquire securities of the target company at a low price. */ Poison pills typically do not require shareholder approval. The board of directors of a company may simply issue, as did the board of Household International

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*/ Poison pills are recent innovations. The first was apparently used in the 1983 takeover battle between Lenox, Inc. and Brown-Forman Distillers Corp. See Lewin, Tactic That's 'Poison' to Bids, N.Y. Times Feb. 22, 1985 p. D-1 Col. 1.

Inc., the "poison pill" security to its shareholders as a dividend. */

Some have questioned the impact of anti-takeover provisions on both individual companies and on the governance and structure of corporations. The Commission's Office of the Chief Economist, as well as others, have begun to analyze the impact of anti-takeover amendments on individual companies. The Office of the Chief Economist believes the currently available data indicate that these provisions both impede takeovers and cause declines in stock prices.

The Investor Responsibility Research Center, Inc. ("IRRC") recently conducted a study of the impact of anti-takeover charter amendments on takeovers. The study reached the following conclusions:

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*/ A poignant example of the Board's authority to dispense with shareholder involvement in this area recently occurred in connection with Rorer Group, Inc. Shareholders approved a recommendation to eliminate the company's poison pill. The vote, however, was non-binding. See Rorer Holders Vote to Rescind Firm's 'Poison Pill' Rule, Wall St. J. (May 9, 1985). Notwithstanding the vote, the board of directors unanimously voted to retain the poison pill provision. See Rorer Group Retains Measure Against Takeovers, Wall St. J. (May 29, 1985).

- Firms with antitakeover amendments are the targets of takeover attempts less frequently than firms without the amendments.

- Takeover premiums are lower by one measure, and unchanged by another measure, in the presence of the amendments. */

- Takeover targets with antitakeover amendments resist takeovers more frequently than targets without the amendments.

- Targets with the amendments are more successful in resisting takeover than targets without the amendments. **/

The study concluded that "these facts suggest both that anti-takeover amendments endow firms with additional power to resist takeovers, and that firms with the amendments behave differently from those without the amendments when confronted with a takeover attempt. * * * The analysis suggests that the amendments appear to be contrary to the interests of shareholders." The study cautioned, however, that "this evidence is of an inferential nature and should not be considered definitive." ***/

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*/ In particular, the I.R.R.C. study states that "antitakeover amendments may not result in higher takeover premiums for shareholders in takeover battles," suggesting that anti-takeover amendments do not necessarily enable management to negotiate higher premiums. I.R.R.C. Report at 9.

**/ Id. at 20.

***/ Id.

As to the impact of anti-takeover provisions on stock prices, the Commission's Office of the Chief Economist has studied the economic impact of supermajority and fair price amendments and poison pills. The Commission's Office of the Chief Economist found a 4% average decrease in stock price from 20 trading days before the announcement of a supermajority provision through 10 trading days after the announcement. */ The study also found that fair price amendments have no significant impact on share price. **/ The Commission's Office of the Chief Economist also studied 15 poison pill issuers, finding that their stock prices decreased by an average of 2% upon announcement; and that based on the prices 10 trading days before the announcement of the poison pill and 40 trading days after the announcement, the stock prices declined an average of 3%. ***/

Another study of anti-takeover amendments found that "[a]lthough inconclusive, the evidence provides weak preliminary support for the hypothesis

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*/ See Exhibit C.

**/ Id.

***/ See Exhibit D.

that anti-takeover amendments are best explained as a device for management entrenchment." */ In contrast, however, at least one other study has concluded that "[a]lthough the results are not unambiguous, the overall impression yielded by the analysis is that the introduction and adoption of anti-takeover amendments is associated with an increase in common stock prices * * * [and] there is no evidence that anti-takeover amendments have a negative impact on stock prices." **/

In addition to the impact of anti-takeover amendments on individual companies, some have echoed concerns reflected in the 1984 House Report and in recent testimony before the Congress about their long-term impact on the governance and

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*/ DeAngelo and Rice, Anti-takeover Charter Amendments and Shareholder Wealth, 11 Journal of Financial Economics 329 (April 1983). This study utilizes several different event dates.

**/ Linn and McConnell, Anti-takeover Charter Amendments, 11 Journal of Financial Economics 397 (April 1983). This study examined stock prices on and between several event dates on which information regarding such amendments was released, such as the date on which the proxy statement describing the amendments were mailed and the dates on which shareholders and boards of directors voted on these proposals.

structure of corporations. */ Since the widespread adoption of anti-takeover amendments is a relatively recent phenomenon, however, their long term effect is uncertain.

Some have contended that certain anti-takeover provisions, particularly supermajority provisions, disenfranchise shareholders by allowing a minority of shareholders to thwart the will of the majority. **/ The Commission is of course concerned with the maintenance of effective shareholder democracy. But it should be noted that such supermajority amendments typically require shareholder approval for their adoption. To this extent, therefore, existing shareholders vote on whether they wish to permit a minority "veto." When shareholder approval of such provisions is required, the proxy rules require full disclosure, including the reasons for the proposal; the advantages

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*/ See, e.g., Statement of Jesse M. Unruh, California State Treasurer, Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary (April 24, 1985); Statement of William Norris, Chairman and CEO of Control Data Corp., Before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee (April 22, 1985).

**/ See, e.g., Hochman and Folger, Deflecting Takeovers: Charter and By-Law Techniques, 34 Bus. Law. 537 (1979).

and disadvantages to incumbent management and to shareholders generally; any existing antitakeover measures; how the proposal will operate; and its overall effects. If a proposal would make the consummation of a hostile tender offer more difficult, this must be disclosed. */ In addition, persons who contemplate becoming shareholders after such provisions are adopted have the opportunity to inform themselves about the nature of the voting and other rights that attach to the company's shares prior to making their investment.

Poison pills, because of their operation and because they typically do not require shareholder approval, appear to raise the most serious concerns. The Commission's concerns about such plans are reflected in its recent amicus brief in Moran v. Household International, Inc., discussed in the Commission's response to Question 12.

12. Does the business judgment rule adequately protect shareholders and the fairness of the tender offer process?

Answer: As noted earlier, the Commission's Tender Offer Advisory Committee endorsed the role of state corporation law in general and the business

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*/ See Securities Exchange Act Rel. No. 15230 (October 13, 1978), 43 Fed. Reg. 49863.

judgment rule in particular. The Commission, as discussed earlier, has noted that, in the change of control context, shareholders would be better served if the courts gave greater recognition to potential conflicts of interest between management and shareholders.

The Commission, */ like the House Committee on Energy and Commerce, **/ had hoped that Norlin Corp. v. Rooney, Pace Inc., et al., ***/ indicated a trend toward modification of the business judgment rule in the tender offer context, at least insofar as it suggested that board of directors' decision in this context would be subjected to heightened judicial scrutiny. ****/ Another

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*/ See Memorandum of Securities and Exchange Commission In Opposition To H.R. 5972 and H.R. 5693, As Amended (July 25, 1982).

**/ See 1984 House Report at 15-16.

***/ 744 F.2d 255 (2d Cir. 1984).

****/ In Norlin, the United States Court of Appeals for the Second Circuit, in upholding a preliminary injunction against several defensive tactics, emphasized that the business judgment rule governs only situations in which the directors are not shown to have a self-interest in the transaction. The court found that the defensive tactics of Norlin's board of directors created "a strong inference that the purpose was * * * to solidify management's control of the company. * * * Where * * * directors amass voting control

(footnote continued)

recent Delaware case may evidence somewhat greater scrutiny in the change of control area. In Smith v. Van Gorkom, */ the Delaware Supreme Court held that the business judgment rule did not insulate a board's decision to approve a merger, where the directors "lack[ed] valuable information adequate to reach an informed business judgment." **/

On the other hand, other recent decisions not only do not reflect a heightened degree of scrutiny in judicial review of change of control transactions, but indeed reflect greater judicial tolerance of many defensive actions. The Delaware Chancery Court, in Moran v. Household International, Inc.,

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(footnote continued from previous page)

of close to a majority of * * * shares in their own hands * * * it strains credulity to suggest that the retention of control * * * played no part in their plans." 744 F.2d at 265.

*/ No. 255 (Del., January 29, 1985).

**/ Id. at 37. The court found that the directors of Trans Union Corporation (1) did not conduct a formal study of the company's worth; (2) were not adequately informed as to the chief executive officer's role in arranging Trans Union's sale and setting the purchase price; (3) did not call in their investment bankers to render a fairness opinion; (4) were not informed that the purpose of the special board meeting was to propose a sale of the company; and (5) were "grossly negligent" in approving the sale of the company without prior notice and without the existence of a crisis or emergency.

C.A. No. 7730 (Del. Ch., January 29, 1985), upheld the adoption of a "poison pill" plan by Household International's directors. In Moran, the court stated that the poison pill plan

> had been properly adopted under Delaware law, is not intended primarily for entrenchment of management and serves a rational corporate purpose * * * [W]hile the plan indirectly limits alienation of shares and the conduct of proxy contests those features are sustainable, within the parameters of the business judgment rule, as necessary to protect the corporation and all its constituencies from the coercive nature of certain partial tender offers.

This case is currently on appeal, and the Commission has filed a brief, amicus curiae, urging that the decision of the court below be reversed. In its brief, the Commission does not argue that this case directly involves application of the federal securities laws, but rather that it involves securities activities regulated by those laws. The Commission's brief argues that the "poison pill" rights plan adopted by Household as an anti-tender offer defense would bar all hostile tender offers for Household, would deter proxy contests by Household shareholders, would entrench Household management, and thus was not in the interests of

Household's shareholders and should not be sustained by the court. */

In Unocal v. Mesa Petroleum Co., **/ the Delaware Supreme Court, reversing the Chancery Court, upheld Unocal's decision not to allow Mesa and its affiliates to participate in Unocal's exchange offer. The court stated in rendering its decision that,

> there was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise. Further, the selective stock repurchase plan chosen by Unocal is reasonable in relation to the threat that the board rationally and reasonably believed was posed by Mesa's inadequate and coercive two-tier tender offer. Under those circumstances the board's action is entitled to be measured by the standards of the business judgment rule. Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some

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*/ Judicial reluctance to look more closely at change of control transactions was also seen in Lowenschuss v. Options Clearing Corp. No. 7972 (Del. Ch., March 26, 1985). In Lowenschuss, the plaintiff's attempt to enjoin an issuer self-tender initiated by Phillips Petroleum Corporation was rejected, with the court upholding the directors' exercise of business judgment.

**/ No. 152 (Del., May 17, 1985).

other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board. */

However, in Minstar v. AMF, Inc., a federal court, explicitly disagreeing with Unocal, invalidated a plan which, the court found, violated New Jersey law because it discriminated between holders of a class of securities by creating certain "rights" which were nontransferable by post-May 20, 1985 shareholders. **/ As a result of this plan, shareholders who purchased after May 20, 1985 were unable to purchase these rights, and the court held that the plan thereby effectively divided AMF's common stock into two classes. Looking in the aggregate at the recent change of control state law cases, the Commission does not believe that it is possible to identify any consistent trend toward heightened judicial scrutiny of change of control related transactions.

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*/ Id. at 25.

**/ Minstar v. AMF, Inc., 85 Civ. 3800 (S.D.N.Y. June 6, 1985). While these rights were not attributes of a typical poison pill plan, the court and the parties in the case described the plan as a "poison pill." In other decisions, more typical "poison pill" plans have been upheld. See, e.g., APL Corp. v. Johnson Controls, Inc., No. 85-C-990 (E.D.N.Y. March 25, 1985); Horwitz v. Southwest Forest Industries, No. CV-R-84-467 (D. Nev. March 19, 1985).

13. What is the appropriate scope of Section 14(e) in tender offers and other contests for control of a corporation?

Answer: Section 14(e) of the Exchange Act provides that it "shall be unlawful for any person to make any untrue statement of a material fact or to omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer * * *." */ Section 14(e) further provides that the Commission shall by rules and regulations "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

The Supreme Court recently construed the scope of Section 14(e). In Schreiber v. Burlington Northern **/ the Court considered whether withdrawal of a hostile tender offer after shares had been tendered, and the substitution of a friendly tender offer for a smaller number of shares, constituted

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*/ 15 U.S.C. 78n(e).

**/ No. 83-2129 (June 4, 1985).

"manipulative" conduct in violation of Section 14(e). The Court rejected the argument that the phrase "fraudulent, deceptive or manipulative acts or practices" in Section 14(e) of the Exchange Act is directed at purposes broader than providing "full and true information to investors." */ Rather, the Court held, "[a]ll three species of misconduct, i.e., 'fraudulent, deceptive or manipulative' listed by Congress [in 14(e)] are directed at failure to disclose." **/ The Court emphasized that

> [n]owhere in the legislative history is there the slightest suggestion that § 14(e) serves any purpose other than disclosure, or that the term 'manipulative' should be read as an invitation to the courts to oversee the substantive fairness of tender offers; the quality of any offer is a matter for the marketplace. ***/

The Court, in discussing the 1970 amendment to Section 14(e) which granted the Commission rule-making authority, stated that "[i]n adding the 1970 amendment, Congress simply provided a mechanism for defining and guarding against those

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*/ Id. at 4.

**/ Id. at 6.

***/ Id. at 10 [footnote omitted].

acts and practices which involve material misrepresentation or nondisclosure. The amendment gives the Securities and Exchange Commission latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself." */

II. Questions Relating to the Commission's Comments on H.R. 5693

The legislative proposal on tender offers submitted to Congress by the Commission in 1984, which was introduced in the 98th Congress as H.R. 5693, was intended to respond to problems the Commission perceived in the tender offer process at that time. As discussed in Chairman Wirth's letter, the Commission objected to H.R. 5693 as amended and ordered reported by the House Energy and Commerce Committee, based on three aspects of the bill.

These were (1) the amendment to the disclosure provisions of Section 13(d), which would have required disclosure of the impact of the purchaser's plans on the issuer's community; (2) the statutory mandate of a minimum offering period of 40 days for a tender offer; and (3) the absence of any limitation on the kind of tender offer that would have triggered restrictions on defensive tactics.

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*/ Id. at 10, n.11.

At a public Commission meeting on May 20, 1985, the Commission heard presentations from a number of experts in the tender offer area. After listening to and questioning these experts, the Commission voted on each major portion of its 1984 legislative proposal on tender offers. The Commission voted unanimously to continue to support its proposal to close the 10-day filing window in Section 13(d) of the Exchange Act. */ The Commission also voted unanimously not to support the remaining elements of its 1984 legislative package. These dealt with golden parachutes, greenmail, issuer self-tenders, and issuances of securities or voting rights during certain tender offers and proxy contests.

The Commission's decision not to reintroduce the major elements of its 1984 legislative proposal was reached giving all due regard to the continuing evolution in practices in this area since May 1984. During the current proxy season, at least 35 issuers have proposed or adopted corporate charter amendments restricting greenmail payments. Also, it appears that greenmail transactions may be declining because issuers are concerned that, by purchasing the shares held by one potential bidder, they will become the target of others.

The Deficit Reduction Act of 1984 (Public Law No. 98-369), enacted in July 1984, may also affect the practice of greenmail. Prior to the enactment of the DRA, a corporation could deduct both

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*/ The details of this proposal are described in the Commission's response to Question 6, supra.

the interest paid on a loan used to secure a "toe-hold" position in a company and 85% of any dividends received from the target. Under the DRA, the 85% corporate dividends-received deduction is reduced by a percentage related to the amount of debt incurred to purchase the stock. This may have the effect of making greenmail and other "toe-hold" acquisitions that utilize borrowed funds more expensive.

Also, portions of the DRA clearly address golden parachutes by imposing a 20% excise tax on their recipients and eliminating of the corresponding tax deduction previously enjoyed by the employer.

Chairman Wirth's letter of January 25, 1985, also raised a number of specific points relating to H.R. 5693. These points, dealing with community impact disclosure, the minimum offering period, the use of trigger mechanisms, and the "balance" of H.R. 5693, are discussed below.

1. Community impact disclosure

The Commission continues to oppose amendment of Section 13(d) of the Exchange Act to require disclosure of the impact of the purchaser's plans on the issuer's community. The Commission believes that such disclosure is unrelated to the objectives of the federal securities laws and outside its expertise.

The Commission believes that current disclosure requirements are adequate to elicit the information concerning changes in

an issuer's business that shareholders would deem material in making investment or voting decisions. Expansion of disclosure requirements to reflect social concerns may result in information material to shareholders' investment and voting decisons being obscured. The Commission believes that "boilerplate" responses will quickly develop. Such "boilerplate" disclosure will provide little hard information and may tend to confuse rather than inform shareholders.

2. Minimum offering period

The 20 business day minimum offering period for tender offers was set by the Commission in 1979, following public comment and analysis over a three-year period. The Commission has, since 1976, considered over 200 letters of comment on the subject. */ The Commission determined that the 20 business day period strikes an appropriate balance under the Williams Act between maintaining neutrality in a tender offer, and providing sufficient time for shareholders to receive, analyze and react to a tender offer. By design, it neither encourages nor discourages tender offers. **/

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*/ See Securities Exchange Act Rel. No. 15548 (February 15, 1979), 44 Fed. Reg. 9956.

**/ See S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967).

The Commission's first proposal in this area was made in 1976. */ The Commission then proposed a 15 business day minimum offering period. The Commission believed that a 15 business day period would facilitate communications during a tender offer and provide a realistic time frame for security holders to evaluate a bid, and certain changes in an offer, before making an investment decision.

In response to the 1976 proposal, the Commission received 111 letters of comment, which expressed divergent views. Some commentators thought the period too long; some considered it too short. Other commentators, including the American Bar Association, questioned the Commission's authority to promulgate any rule establishing a minimum offering period. These commentators believed the seven and ten business day periods implicit in the Williams Act to be adequate.

In 1979, the Commission proposed a 30 business day minimum offering period, to be extended for an additional 10 business days following a price increase or an increase in dealers' soliciting fees. **/ The Commission solicited public comment on

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*/ Securities Exchange Act Rel. No. 12676 (August 2, 1976), 41 Fed. Reg. 33004.

**/ Securities Exchange Act Rel. No. 15548 (February 5, 1979), 34 Fed. Reg. 9956.

whether the 30 business day minimum offering period ought to be longer or shorter and, if so, what period should be adopted. In response to its 1979 release, the Commission received 105 letters of comment. As in 1976, these comments reflected divergent views on the question of the length of the minimum offering period and the Commission's authority to adopt such a rule. */

In 1979, the Commission's Directorate of Economic and Policy Analysis conducted a study of 153 tender offers made during the years 1974 through 1978. This study concluded that,

> given that the proposed rules are designed to correct past abuses and not to fundamentally alter current tender offer practice, it would seem advisable to set minimum initial offer and extension periods which do not significantly affect more than half of the tender offers. This suggests that the median initial offer and extension periods would be good upper bounds on the minimum offer periods to be established by the proposed rules.

The study found the median initial offer period of tender offers during that period to be 15 business days. The median extension of an offer during that period was six business days. The study found that 75% of all offers had an initial offer period

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*/ See Summary of Comments Relating to Proposal Tender Offer Rules and Schedule, Securities Exchange Act Rel. No. 15548 (February 5, 1979), File No. S7-770.

of less than 24 business days. The study also showed that the median duration of a tender offer had increased from 13 business days in 1974 to 20 business days in 1978.

Both the Commission and Congress recognized that delays substantially increase expenses for a bidder and tendering shareholders, and reduce the chances for success of a tender offer. The 20 business day minimum offering period, determined after extensive public comment and analysis, strikes a balance under the Williams Act between maintaining neutrality, and provides sufficient time for the tender offer to be published and for shareholders to receive, digest and respond to the offer, while favoring neither bidders nor managements. In case of an increase in the consideration or broker's fees, the period is extended 10 days. Moreover, the 20 business day period avoids tying-up securities tendered by shareholders any longer than necessary.

With respect to the ability of management to respond to a tender offer, the 20 business day minimum offering period is more than adequate. In fact, under Rule 14e-2, management's response must occur within 10 business days from the publication of a third-party offer. As this is routinely accomplished under the current rule, the Commission sees no reason to doubt the adequacy of the 10 business day period under Rule 14e-2, much less the 20 business day minimum offering period.

3. Trigger mechanism

The Commission advised the House Energy and Commerce Committee that specific triggers should be included in any tender offer legislation to provide for additional clarity and certainty. The Commission expressed a preference that the triggers be incorporated in the statute itself, not in Commission rules. The Commission regrets any misunderstanding that may have arisen last year with respect to the Commission's continued support of statutory triggers.

4. "Balance" of the legislation

The Commission's original proposal, while it restricted specific defensive tactics, also proposed closing the 13D ten-day window in Section 13(d) of the Exchange Act, thereby providing management with additional time to consider its alternatives prior to the commencement of a tender offer.

As noted above, while the Commission has voted not to reintroduce most elements of its 1984 legislative package, it continues to support its proposal to close the 10-day window. Of course, the Commission stands ready to assist the Subcommittee in examining various approaches to regulating current tender offer practices.

EXHIBIT A

A Study

by

The Office of the Chief Economist
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

April 19, 1985

The Economics of Any-or-All, Partial, and Two-Tier Tender Offers

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The views expressed herein are those of the Office of the Chief Economist only. The Commission has expressed no view on this study.

The Economics of Any-or-All, Partial, and Two-Tier Tender Offers

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In Release No. 34-21079 the Commission requested public comment on certain recommendations proposed to the Commission by its Advisory Committee on Tender Offers. That release incorporated a study by the Office of the Chief Economist (OCE) of successful tender offers in calendar years 1981-1983. This memorandum is an updated and revised study of tender offers in calendar years 1981-1984. In addition to updating the original study through 1984, this improved study expands upon the initial study by including data on the frequency and effect of negotiated versus non-negotiated tender offers. This study also examines the fraction of shares tendered into two-tier, partial and any-or-all tender offers.

The theory, discussion, and results of this revised study are broadly consistent with those of the initial OCE study. Notably, the relative frequency of two-tier tender offers has continued to decline in 1984 while the frequency of negotiated tender offers has continued to increase to more than two-thirds of all offers made in 1984.

This memorandum is organized into several sections. The first section is a brief overview of the criticism of partial and two-tier offers. The second section describes our data and empirical methodology. The third section considers some theoretical explanations of partial and two-tier tender offers. The fourth section relates our empirical information to the controversy. Section five reviews multiple bidder contests. A summary and conclusion ends the paper.

Our study reveals these characteristics of any-or-all, two-tier and partial tender offers initiated between January 1981 and December 1984.

- Any-or-all offers are more frequent than partial and two-tier offers (159 as opposed to 69). Two-tier tender offers are now quite infrequent, comprising just 7 of 82 offers in 1984. (See Table 1a.) The incidence of any-or-all offers is higher among smaller targets while two-tier offers predominate among medium-size and large targets. (See Table 2.)
- More than half of all tender offers are negotiated. Two-thirds (100 of 148) of the contests that begin as any-or-all offers are negotiated with target management from the start. Half (21 of 40) of tne contests initiated by two-tier offers are negotiated from the start. However, relatively few (7 of 40) initial partial offers are negotiated. (See Tables 1b and 1c.)

- More than three-quarters of all tender offers are ultimately negotiated. Most (133 of 159) of the contests that culminate in any-or-all offers are ultimately negotiated with target management. Virtually all (35 of 38) successful two-tier offers are negotiated. Partial offers are less frequently negotiated (12 of 31). (See Tables 1b and 1c.)
- Any-or-all premiums and two-tier blended premiums are very similar in magnitude -- 71 percent of two-tier premiums exceed 40 percent while 70 percent of any-or-all premiums do so. (See Table 5.) The average premium for any-or-all offers is 59.6 percent compared to an average blended premium in two-tier offers of 54.5 percent.
- The first-tier of a two-tier offer at 62.8 percent is very similar to the average bid premium of an any-or-all offer at 59.6 percent. However, the average bid premium of partial offers is lower at 34.4 percent. (See Table 6.)
- Over two-thirds of the 38 two-tier offers have less than a 20 percent difference between the two-tiers. In contrast, less than half of the 30 partial offers have less than a 20 percent difference between the two tiers. (See Table 8.)
- A higher proportion of outstanding shares are tendered on average into any-or-all offers (73

percent) than into two-tier offers (62 percent) or pure-partial offers (34 percent). (See Table 9.)

I. The Controversy Behind Partial and Two-Tier Tender Offers

In Release No. 34-21079, the Commission describes the concerns surrounding partial and two-tier offers. Central to these concerns is that target shareholders may be induced to tender to a partial or two-tier offer when an alternative any-or-all offer may have a higher overall premium. A two-tier offer might be accepted over an any-or-all offer in this case because shareholders tender to a high first tier to avoid a relatively low second tier. Though shareholders would be better off on an overall basis if they tendered to the any-or-all offer rather than tendering to the two-tier offer, shareholders are not certain which offer will be accepted. A situation is created where shareholders may tender to the first tier of the two-tier bid because of fear of being forced to accept a lower second-tier offer if the bidder obtains control in the two-tier offer. Commentators suggest that this process is coercive and encourages shareholders to tender when the overall two-tier premium is not as attractive as existing or potential any-or-all offers.

Our research focuses on identifying partial and two-tier offers and computing offer or first-tier premiums and "blended" premiums (which combine first-tier and second-tier premiums). These premiums are compared for evidence of shareholders accepting relatively low overall bids in partial or two-tier

offers for indications of coercive behavior. In addition, the frequency of such offers and the role of target firm management in negotiating these offers are studied. It is hoped that the evidence presented will provide a springboard for further discussion and research.

II. Data and Methodology

This study is based on 14D filings with the SEC by bidding firms and target firms. From these, we take all "successful" cash offers (defined as those in which any target shares at all were purchased) executed between January 1981 and December 1984. For these offers, we compile a data base detailing offer terms, pre- and post-offer prices of target shares, and other information such as total number of target shares and number of shares previously held and sought by the bidder. 1/

1/ In a few cases it was necessary to eliminate a tender offer from our sample due to lack of contemporaneous price information about the target firm. Tender offers were also excluded if they were clean-up offers after the bidder had already obtained control of the firm. A list of excluded offers is available upon request.

Transactions involving an exchange of shares, as opposed to tender offers, are specifically excluded from our sample. For example, in the complicated Martin Marietta/ Bendix case, we include only the various tender offers in which shares were purchased. These offers include Martin Marietta's offer for Bendix and Bendix's offer for Martin Marietta. United Technologies friendly tender offer for Martin Marietta is not included because no shares were purchased under it and Allied's merger with Bendix is also excluded since no tender offer was involved.

Data is also extracted from 14D filings on the nature of any written agreements between bidder and target managements. A negotiated offer is defined as one made pursuant to a written agreement with target management. Included are formal merger agreements, stock option agreements that give the bidder the right to purchase the target's authorized but unissued shares, or stock purchase agreements that give the bidder the right to purchase the shares held by target managers and other large holders (if not tendered). These written agreements always call for target management to also recommend the offer to their shareholders. The general effect of these agreements is to give the preferred bidder an advantage over competing bidders. Since the initial bid of a takeover contest is less likely to be negotiated than the ultimately successful bid, results are reported for whether or not the initial bid of a contest is negotiated and for whether or not the successful bid is negotiated. An initial bid may be superceded by a bid from a different bidder or by a revised bid from the same bidder.

In general, tender offers may be divided into two basic groups depending on whether prorationing is a factor in the bid. An any-or-all offer states that the bidder will buy any tendered shares of the target firm. Typically, the offer is conditional on a minimum number of tendered shares sufficient to insure control after the offer. In an any-or-all offer, target shareholders knows that all of their tendered shares

will be purchased at the offered premium as long as the minimum conditions are met.

If the bidder seeks less than all target shares, he bears the risk that too many shares will be tendered. Consequently, the second type of tender offer is one in which the bidder states a maximum number of shares to be purchased in addition to a minimum. If the offer is oversubscribed, the tendered shares will be subject to prorationing. When the offer is executed under prorationing, each tendering account has the same fraction accepted. Prorationing requirements ensure that each target shareholder receives a proportionate share of the terms of the tender offer.

This second type of offer may be divided into several subgroups. A pure partial offer we define as one in which there is no announced second-tier offer during the tender offer and no clean-up merger or tender offer closely following the execution of the tender offer. If the partial offer is for control of the target firm and is successful, a minority interest is left trading the target firm's shares in the market. More commonly, partial offers are for less than 50 percent. In any case, the trading price of the unpurchased target shares is the "second tier" of a partial offer.

A two-tier offer combines a partial tender offer for control with a subsequent merger. In a negotiated two-tier offer, the bidder, at the time of the first-tier offer, agrees with target management on the terms of the subsequent

merger. The first tier is for a controlling interest in the target firm and almost always offers cash for the target shares. The second tier is likely to involve an exchange of securities for the remaining shares. The first-tier price is offered to shareholders on a prorata basis and the value of the second-tier is usually less than the first-tier offer on a per-share basis.

A non-negotiated two-tier offer lies between the pure partial offer and the negotiated two-tier offer. although no second-tier merger terms are agreed to at the time of the original offer for control, the bidder announces an intention to cause a merger. The second-tier price in non-negotiated two-tier offers is again generally lower than the first-tier price and it usually offers securities for the target shares.

Central to our research is the calculation of percentage premiums paid in tender offers over and above previous market values. As a measure of the effect of tender offers on target shareholder wealth, we compute a "blended" price that reflects the overall price paid to all outstanding shares. The price paid to each "tier" is weighted by the fraction of shares receiving that price. We express a blended price as:

$$P_B = (F \times P_T) + ((1-F) \times P_E),$$

and a blended percentage premium as $((P_B/P_O)-1) \times 100$.

where: P_B = the blended price of the offer,

P_T = the per-share, first-tier offer price,

P_E = post-offer market price of target shares,

F = the fraction of shares purchased in the first tier of the offer,

P_O = pre-contest market price of target shares.

The data required for this formula are readily available. The tender offer price (P_T) is simply the cash bid of the tender offer. The pre-contest market price of the target shares (P_O) is measured 20 trading days before the announcement of the initial offer of a contest, even where the initial offer is unsuccessful and even where the initiating offer is a merger offer. This earlier price is used to lower the probability that leakage of information about an impending tender offer has raised P_O above its value in the case of no tender offer.

We estimate the second tier or clean-up price (P_E) in each type of offer as the market price of target shares 20 trading days after the expiration of the offer. In pure partial offers and non-negotiated two-tier offers, the face value of the second-tier is unspecified in the offer. Even in negotiated two-tier offers, where the second-tier terms are set, the actual value of the security used may not equal its face value or the value claimed by the bidder. Consequently, when the second tier consideration is other than cash, we use the market value of the securities, not the value as stated by the bidder. In those any-or-all offers where very few public shares remain after the offer, we use the stated terms of the second step cash merger.

In an any-or-all offer, the blended premium is essentially equal to the offer premium in the first tier. This is because a high proportion of shares are typically tendered into an any-or-all offer, and because the second tier typically is a cash merger at the same price as the offer. However, when an any-or-all offer is undersubscribed, with no subsequent merger, the calculation of the blended premium will reflect that shareholders are opting for the (typically higher) second-tier market value.

III. Why Bidders Use Partial and Two-Tier Tender Offers

The formula for the blended premium can be used to show that any partial offer has a matching any-or-all offer in which target shareholders receive the algebraically equivalent premium. For example, a two-tier offer of $20 for 50 percent of the outstanding shares and securities worth $10 for the other 50 percent is algebraically equivalent to a uniform offer of $15 for any-or-all shares outstanding. The premium of the any-or-all offer equals the blended premium of the two-tier bid. Total outlay to the acquiring firm is equal under these bids assuming both induce 100 percent tenders. What are the economic differences, then, between partial and two-tier offers and any-or-all offers, and why are partial or two-tier tender offers preferred by some bidders? Several explanations have been suggested:

1. A partial tender offer leaves outstanding a substantial equity interest in the target firm with the value of the

outstanding shares determined in a competitive exchange market. In its report, the SEC Advisory Committee on Tender Offers cites several benefits of partial offers in addition to those listed below. 2/

A related point is that a partial tender offer is conditional in that it obligates the bidder to purchase only up to a pre-set maximum number of shares regardless of how many shares are tendered. The partial offer therefore sets an upper bound on the total cash outlay required for the bidder to obtain the desired fractional interest in the target. This allows the bidder to eliminate the uncertainty that exists with any-or-all offers about how many shares will be tendered in response to a pre-set premium.

2. A two-tier tender offer can increase the incentive for target shareholders to tender by offering a high first-tier premium and a relatively low second-tier premium. The greater the difference between the first-tier premium and the second-tier premium, the greater is the opportunity cost to target shareholders of not tendering if the offer succeeds. Under certain conditions, target shareholders can be induced to tender into a two-tier offer even though its blended premium is less than the uniform premium of an alternative any-or-all offer that is forthcoming. As identified by Professor Bradley,

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2/ SEC Advisory Committee on Tender Offers, Report of Recommendations, July 8, 1983, pp. 24-25.

this situation is analogous to the classic prisoner's dilemma. 3/

The prisoner's dilemma analysis as applied to two-tier tender offers is clearer with an example. Suppose a target firm with 1,000 outstanding shares has a market value of $10 per share before the tender offer, for a total equity value of $10,000. Assume that a bidder is willing to pay $5,000 above this market value for control of the target firm. Therefore, the bidder is willing to pay $15 per-share in an any-or-all offer. Let us further assume that there is a strong expectation that in the near future (say 50 days) another bidder will offer $18 per share through an any-or-all offer.

Despite the expectation of a higher offer in the near future, the first bidder can fashion a two-tier offer to pressure target shareholders into responding while still paying only a $5,000 premium. Specifically, the first bidder offers $20 per-share for 500 shares on a proration basis, and $10 per share for the other 500 shares, to be paid after the

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3/ Michael Bradley, "Interfirm Tender Offers and the Market for Corporate Control," Journal of Business, 1980, pp. 345-376. See especially pp. 355-356. The prisoner's dilemma is created by placing two suspected perpetrators of a crime in separate rooms and presenting each with the following proposition. If you confess and your partner does not, he receives the harshest punishment and you go free. If he confesses and you do not, then you receive the harshest punishment and he goes free. If both confess, then both receive moderate punishment. The rational prisoner will confess to avoid the harshest punishment, even though no confession results in both going free.

first offer is executed. The blended price is $15, which equals the outlay in an any-or-all offer of $15 per share.

Faced with this offer, each target shareholder will reason that: (i) if other shareholders tender, then I should tender to avoid receiving only $10 for my shares; (ii) if other shareholders hold, then I should tender to receive the first-tier price of $20 per-share, with little prorationing risk if the offer succeeds. This reasoning will lead rational shareholders to tender. The result holds even though all shareholders know that concerted, organized refusal to tender would be the best strategy since it would allow by assumption all to receive $18 per share in the near future from an alternative bidder. The prisoner's dilemma that is created by the two-tier offer causes the shareholders to accept the lower-valued offer having a $15 blended price.

We studied all control contests involving partial or two-tier offers in between 1981 and 1984 for evidence that any-or-all offers are disadvantaged relative to partial or two-tier offers in contests or that shareholders may be accepting a lower return by approving a partial or two-tier offer. As detailed in Section V, there is virtually no evidence to support the suggestion that two-tier or partial offers can defeat competing any-or-all offers while providing lower premiums to target shareholders.

3. Under SEC regulations in effect before December 15, 1982, a two-tier or partial tender offer forced shareholders

to commit to tender their shares earlier than they would under an any-or-all tender offer. This incentive resulted from the SEC's increase in the minimum offer period from 10 calendar days to 20 business days in 1979. At the same time, the minimum period for the proration pool remained at 10 calendar days. Therefore, while an any-or-all offer gave target shareholders 20 business days to make their tendering decisions, the partial or two-tier offer forced target shareholders to decide within 10 calendar days or forfeit their right to prorata acceptance of their tendered shares.

Earlier commitments by target shareholders may benefit the bidding firm because target shareholders have less time to consider alternatives or wait for additional offers. This advantage to bidders of prorated offers has been eliminated since December 15, 1982, when the SEC extended proration rights throughout the offering period. We measure a substantial reduction in the incidence of two-tier and partial tender offers relative to any-or-all offers following this rule change.

IV. Empirical Results

A. Frequency of Two-Tier and Partial Tender Offers

Table 1a presents a breakdown by year and type of 228 tender offers between January 1981 and December 1984. There are 159 any-or-all offers accounting for 70 percent of the total. There are 69 partial and two-tier offers accounting for the remaining 30 percent. The relative incidence of

any-or-all offers has increased steadily over the four years, from 58 percent in 1981 to 80 percent of the total in 1984. The incidence of two-tier offers has fallen to nine percent of the total in 1984.

B. Frequency of Negotiated Tender Offers

Table 1b presents a breakdown by year and by whether or not the initiating offer is negotiated with target management and by whether the successful tender offer is negotiated. More than half of all initiating offers are negotiated at the start (as of their public announcement). The proportion of all tender offer contests that are initiated by negotiated offers has increased steadily from 43 percent of the total in 1981 to 63 percent in 1984. Ultimately, more than three-quarters of all successful tender offers are negotiated. The proportion of tender offers that are ultimately negotiated has also increased steadily from 68 percent of the total in 1981 to 87 percent of the total in 1984. Negotiation now appears to be the rule rather than the exception.

Table 1c presents a breakdown of the frequency of tender offers by their type as well as by whether or not they are negotiated. Offers are categorized by the type and agreement of both the initial offer of the contest and by the type and agreement of the offer that is ultimately made. Any-or-all offers are the most frequent type of initiating offers at 65 percent of the total and two-thirds (100 of 148) of these are negotiated. Of those offers that are ultimately any-or-all

(159 of 228), 83 percent are negotiated at the end. About half of all initiating two-tier offers (21 or 40) are negotiated from the start, and virtually all (35 of 38) of the offers that ultimately take the two-tier form are negotiated in the end. Pure-partial offers are the least likely to be negotiated. Few initial partial offers (7 of 40) and somewhat more final partial offers (12 of 31) are negotiated.

C. Size of Target Firms

Table 2 reports the average size of target firms by type of tender offer (ultimately made). Any-or-all offers are used generally for smaller target firms. Target firms of any-or-all offers average $231 million in total equity value, as measured using the pre-contest stock price times the fully diluted number of shares. In contrast, targets of two-tier offers average $631 million and targets of pure partial offers average $447 million.

Tables 3a and 3b provide more detailed information on the distribution of target size by type of offer. Table 3a shows the absolute and relative distribution of target size by type of offer. This table reveals that 81 percent of two-tier offers are for target firms of more than $50 million in equity value. On the other hand, only 47 percent of any-or-all offers and 48 percent of partial offers are for these larger firms.

Table 3b reports the percentage of each type of offer in each class of target size. As the size of the target firm

increases, two-tier offers become increasingly prevalent and any-or-all offers play a lesser role. For target firms with less than $5 million in equity value, 90 percent of the 21 tender offers made are any-or-all offers and none are two-tier. For the very largest firms (more than $1 billion in equity value), only 38 percent of the 13 offers are any-or-all offers, while 47 percent are two-tier. Clearly, two-tier tender offers play an important role in takeover contests for large targets while any-or-all offers are used more for smaller targets.

D. Premiums in Tender Offers

1. Blended Premiums

Blended premiums for the three different types of tender offers are compared by year in Table 4a. The four-year averages show that the mean premium for any-or-all offers is highest at 59.6 percent, compared with a slightly lower premium of 54.5 percent for two-tier offers. Partial offers yield a much lower average premium of 20.1 percent.

A closer look at the distribution of blended premiums (Table 5) further reveals the similarity between the magnitude of any-or-all and two-tier premiums. For example, 71 percent of two-tier premiums are greater than 40 percent while 69 percent of the any-or-all offers exceed 40 percent premiums. Therefore, we do not find a substantial difference between any-or-all premiums and two-tier premiums.

Blended premiums for negotiated and non-negotiated tender

offers are compared by year in Table 4b and by the three different types of tender offers in Table 4c. Premiums ultimately received by target shareholders are nearly as great (51.7 percent) when the initiating offer is negotiated as when it is not (55.5 percent). Below is a ranking from high to low of average blended premiums ultimately received, classified by type of initiating offer and whether the initiating offers was negotiatd.

non-negotiated any-or-all (67.5 percent)
negotiated two-tier (58.5 percent)
negotiated any-or-all (52.6 percent)
non-negotiated two-tier (51.9 percent)
non-negotiated partial (40.2 percent)
negotiated partial (18.2 percent).

On average, target shareholders fare best when the contest is initiated by a non-negotiated, any-or-all offer. They fare worst when the initiating offer is a negotiated, partial offer. In general, shareholders receive substantial premiums (averaging more than 50 percent) when the takeover contest begins or ends with either an any-or-all offer or a two-tier offer. This is true irrespective of whether or not the initiating offer or the successful offer is negotiated. In sum, these results show that, ignoring partial offers, there are no substantial differences in the average blended premiums ultimately received. It is important to note (as detailed below) that partial offers are generally made for less than a controlling (51 percent) interest.

2. Bid Premiums

The bid premium is the first-tier premium. As shown in

Table 6, the average bid premium is similar for any-or-all (59.6 percent) and two-tier offers at (62.8 percent). The pure partial bid premium is 32.2 percent. Referring back to blended premiums, it is clear that the blended premiums in two-tier and pure partial offers are less than their corresponding bid premiums. The generally lower second-tier price lowers the blended premium, especially for partial offers.

3. First-Tier and Second-Tier Premiums

Table 7 divides the blended premium of two-tier and pure partial offers into its components -- the first-tier and second-tier premiums. In every year the mean second-tier premium is positive for both two-tier and for pure partial offers, indicating that the market value of the second tier generally exceeds the pre-offer market price of the target. The average second-tier premium is 44.8 percent for two-tier offers and 12.0 percent for pure partial offers. These second-tier premiums are clearly substantial on average.

Table 8 reports data on the difference in magnitude between first-tier and second-tier prices (P_T relative to P_E). This computation addresses the concern that target shareholders are induced to tender to two-tier and partial offers because of large differences between the values of the two tiers. The per-share value of the first-tier (P_T) is 15.7 percent greater than the second-tier (P_E) for two-tier offers on average. For partial offers, the value of the first-tier price is 24.2 percent larger than the second-tier on average.

In two-tier offers, this difference between the value of the two tiers is not very large, especially when compared to the difference in pure partial offers.

Table 8 provides a detailed breakdown of the relative difference between the value of the two tiers in two-tier and pure-partial offers. The first-tier price exceeds the second-tier price by less than 20 percent for 71 percent of the two-tier offers. This is true for only 48 percent of the partial offers.

4. Fraction Tendered and Purchased

Table 9 presents an accounting of the disposition of the shares of tender offer targets. It shows the average percentage of outstanding shares (fully diluted) that are held by the bidder prior to the offer, or purchased privately (outside of the bid) from large holders. It also shows the percentage of shares that are tendered into the offer, and the percentage purchased in the tender offer. These data are from the bidder's final (amended) 14D filing with the Securities and Exchange Commission. Averages are reported for successful any-or-all, two-tier and partial offers, and by whether or not the offer is ultimately negotiated.

On average, any-or-all bidders purchase through the public offer 73 percent of the total outstanding shares. Combined with their average prior holding of 13 percent, any-or-all bidders acquire, on average, a total of 86 percent. Two-tier bidders purchase an average of 46 percent of outstanding

shares through their public offers, giving a total holding of 50 percent when combined with their prior holdings of four percent. Note that two-tier offers provide bare majority control, on average, before the second tier. Pure-partial bidders purchase an average of 22 percent, which is insufficient to give them majority control even when combined with their average prior holdings of 14 percent. Generally, any-or-all and two-tier bids are for majority control while partial offers are not.

The average fraction tendering into any-or-all offers (73 percent) is higher than that into two-tier offers (62 percent) and higher than that into pure-partials (34 percent). For each type of offer, more shares are tendered, on average, into negotiated offers than into non-negotiated offers. Specifically, 76 percent tender into negotiated any-or-all offers compared with just 57 percent into non-negotiated any-or-all offers. Similarly, 63 percent tender into negotiated two-tier offers compared with an average of 50 percent tendering into non-negotiated two-tier offers. Finally, 50 percent tender into negotiated partial tender offers compared with 24 percent into non-negotiated partial offers.

These data on tendering contradict three important pieces of conventional wisdom. First, a surprisingly large fraction of equity holders forego the opportunity to participate in these lucrative tender offers. Without speculating about

underlying motivations for this result, it is notable that, even for the high-response any-or-all offers, there remains untendered on average 14 percent of the outstanding shares.

The second surprising result is that the tendering response is actually less for the supposedly more coercive types of offers. In particular, the response is greatest for any-or-all offers and less for two-tier and partial offers. The tendering response runs directly counter to the coerciveness of the offer, as measured by the difference between tiers (shown in Table 7).

The third surprising result is that the tendering response for each type of offer is less for non-negotiated offers than it is for negotiated offers. This contradicts the popular notion that non-negotiated offers are more coercive than negotiated offers. Apparently, many stockholders heed target managements advice in determining whether to tender or hold.

V. Multiple Bidder Contests

Table 10 lists the outcomes of multiple-bidder contests for corporate control between 1981 and 1984 with a view toward the question of whether partial or two-tier offers have a tactical advantage over other kinds of offers. It includes all multiple-bidder contests in which shareholders chose between a partial or a two-tier offer involving pro-rationing and an any-or-all tender offer or a merger offer with no pro-rationing. This survey shows that during this time period no (non-negotiated) partial or two-tier tender

offer beat any (unenjoined) any-or-all tender offer or merger proposal offering a higher premium.

Of the 18 head-to-head contests between two-tier/partial and any-or-all offers, five were won by two-tier or partial offers. Of these, three (Gulf Oil, HMW Industries and Interpace) were won with a higher blended premium than that available from the competing any-or-all offer. In a fourth case (Conoco), the higher valued any-or-all offer was enjoined by the Justice Department. The one case in which a two-tier offer beat a higher valued any-or-all offer is that of Enstar Corp. in 1984. Here, the success of the two-tier offer was at least partly attributable to certain agreements between the two-tier bidder and the target. The failed any-or-all offer was non-negotiated and conditional on the recision of these agreements.

VI. Conclusion

This study of 228 tender offers between 1981 and 1984 has several noteworthy results. In general, any-or-all offers are more frequent than partial and two-tier offers, with the former accounting for 159 of the total 228 offers, and the relative incidence of any-or-all offers is growing while the incidence of two-tier offers is diminishing. In addition, the incidence of any-or-all offers is higher among smaller targets, while two-tier offers predominate among moderate-sized and large targets. This empirical regularity may reflect an underlying economic difference between any-or-all and two-tier

offers, with the latter types favored by bidders for relatively large targets. This implies that any regulatory disincentives currently under consideration to partial and two-tier offers may have more important effects for larger takeover targets than smaller targets.

The incidence of negotiated tender offers is increasing. Almost two-thirds of the successful offers commenced in calendar 1984 were negotiated with target management from the start or they were initiated by negotiated offers. Of these successful 1984 offers, 87 percent were negotiated with target management as of their expiration. Both these percentages for initial and ultimate offers have increased steadily throughout the 1981-1984 period. This suggests that the negotiating positions of target managers have steadily improved in recent years so that negotiated tender offers are now the rule rather than the exception.

We present detailed comparisons of uniform premiums in any-or-all offers with two-tier and partial offers. The average premium for the 159 any-or-all offers is highest at 59.6 percent relative to the pre-offer market price. The 38 two-tier offers yield an average blended premium of 54.5 percent, while the 30 pure partial offers yield 20.1 percent. Any-or-all premiums and two-tier blended premiums are very similar in magnitude -- 71 percent of two-tier premiums exceed 40 percent while 70 percent of any-or-all premiums do so.

The two-tier offer yields an average first-tier premium of 62.8 percent, virtually identical to the corresponding premium for any-or-all offers of 59.6 percent. The average second-tier premium of 44.8 percent for two-tier offers is less than the first-tier premium, but it is considerably larger than the "implicit" second-tier premium of 12.0 percent afforded by partial tender offers. Indeed, the average second-tier premium for two-tier offers (44.8 percent) exceeds the average blended premium for pure partial offers (20.1 percent). Therefore, two-tier offers are nearly as beneficial to target shareholders as any-or-all offers, and two-tier offers are significantly more beneficial than pure partial offers which have no second-tier purchases by the bidders.

The study also investigates the relative differences between first-tier and second-tier premiums for two-tier and partial tender offers. Nearly three-fourths of the 38 two-tier offers have less than a 20 percent difference between the first and second-tier values. In contrast, less than half of the 25 pure partial offers have less than a 20 percent difference between the first- and second-tier prices. Therefore, while the second tier of a two-tier offer generally provides a lower premium than does the first-tier, the difference in magnitude between the two values is not large, especially when compared to pure partial offers. The average first-tier price is 15.7 percent larger than the second-tier price for two-tier offers, while it is 24.2 percent larger than the implicit second-tier price in pure partial offers.

A higher proportion of outstanding shares are tendered into any-or-all offers (73 percent) than into two-tier offers (62 percent) or into pure-partial offers (34 percent). Since relatively more target shareholders are able to resist tendering into two-tier and partial tender offers than any-or-all offers, these results contradict claims that shareholders are "stampeded" into tendering into two-tier and partial offers due to their greater coerciveness. In addition, the greater fraction of shares tendered into negotiated tender offers compared to non-negotiated tender offers, suggests that target managements can and do influence the tendering decisions of their shareholders.

In view of these results, it probably would not be beneficial to adopt regulatory changes which would encourage the use of partial tender offers instead of two-tier offers. The second-tier premium in two-tier offers is on average three times as large as the implicit second-tier value in partial offers. Any substitution of partial offers for two-tier offers would deprive target shareholders of this greater return.

Also, these results suggest that it is problematic whether target shareholders would benefit from further regulatory inducements to use any-or-all instead of two-tier offers. First, such a switch increases the returns to target shareholders only modestly, since any-or-all premiums on average exceed the blended premiums for two-tier offers by a

relatively small margin. Second, in view of this data it is likely that forcing the use of any-or-all offers will deter some takeovers, especially of larger targets. The losses to target shareholders from such foregone transactions, even if they are few, can outweigh the benefits of higher any-or-all premiums. Finally, the regulatory change of December 1982 appears to have substantially eliminated the advantage that two-tier offers had.

TABLE 1a

Number of Tender Offers[1], By Type: 1981-1984
(percents in parentheses)

Year	Type of Offer[2]						Total
	Any-or-All[3]		Two-Tier[4]		Pure Partial[5]		
1981	35	(58)	12	(20)	13	(22)	60 (100)
1982	32	(61)	14	(27)	6	(12)	52 (100)
1983	26	(76)	5	(15)	3	(9)	34 (100)
1984	66	(80)	7	(9)	9	(11)	82 (100)
TOTAL	159	(70)	38	(17)	31	(13)	228 (100)

Notes:

[1]The data in this and subsequent tables cover cash tender offers that were partially or fully successful in that bidders acquired some or all the shares sought through the offer.

[2]Type of offer is the final form after all amendments to the offer.

[3]Any-or-all offers are for all tendered shares, as long as minimum conditions are met.

[4]In two-tier offers, the offer for shares is in two steps. In an explicit two-tier offer, the bidding firm agrees at the time of the initial offer with target management to purchase the remaining shares following the execution of the first-tier partial offer. In implicit two-tier offers, a second tier is revealed shortly after the execution of the tender offer.

[5]Pure partial offers are for less than all shares. There is no clean-up merger or tender offer closely following the execution of the tender offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 1b

Number of Negotiated Tender Offers: 1981-1984
(percents in parentheses)

Stage and Negotiation Results of Offer

	Initial Offer		Ultimate Offer		
Year	Negotiated	Non Negotiated	Negotiated	Non - Negotiated	Total
1981	26 (43)	34 (57)	41 (68)	19 (32)	60 (100)
1982	28 (54)	24 (46)	39 (75)	13 (25)	52 (100)
1983	21 (62)	13 (38)	28 (82)	6 (18)	34 (100)
1984	52 (63)	30 (37)	71 (87)	11 (13)	82 (100)
TOTAL	127 (56)	101 (44)	179 (79)	49 (21)	228 (100)

Note:

A negotiated tender offer is defined as one made pursuant to, or in association with, a written agreement with target-firm management. The initial offer is the first offer made by any bidder, not necessarily the bidder making the ultimate offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 1c

Number of Tender Offers, By Stage, Type and Negotiation Results
(percents in parentheses)

Type of Offer and Negotiation Results	Stage of Offer: Initial Offer	Stage of Offer: Ultimate Offer
Any-or-All Offers:		
Negotiated	100 (44)	133 (59)
Non-negotiated	48 (21)	26 (11)
Two-Tier Offers:		
Negotiated	21 (9)	35 (16)
Non-negotiated	19 (8)	3 (1)
Pure Partial Offers:		
Negotiated	7 (3)	12 (5)
Non-negotiated	33 (15)	19 (9)
Total	228 (100)	228 (100)

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 2

Average Size[1] of Targets, by Type of Tender Offer: 1981-1984
($ millions)

Year	Type of Offer[2]			
	Any-or-All	Two-Tier	Pure Partial	Total
1981	$138	$996	$883	$471
1982	63	591	135	213
1983	142	154	201	149
1984	396	428	107	367
TOTAL	$231	$631	$447	$327

Notes:

[1]Size is measured as the market value of target's equity. It is computed as the number of fully diluted common shares multiplied by the pre-offer market price of those shares.

[2]Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 3a

Number of Tender Offers, By Size and Type
(percents in parentheses)

Target Size ($ million)*	Type of Offer[1] Any-or-All	Two-Tier	Pure Partial	Total
Less than 5m	19 (12)	0 (0)	2 (6)	21 (9)
5m to 10m	11 (7)	1 (3)	5 (16)	17 (7)
10m to 50m	53 (32)	6 (16)	9 (30)	68 (30)
50m to 100m	21 (14)	3 (8)	3 (10)	27 (12)
100m to 500m	44 (28)	15 (39)	10 (32)	69 (30)
500m to 1,000m	6 (4)	7 (18)	0 (0)	13 (6)
Greater than 1,000m	5 (3)	6 (16)	2 (6)	13 (6)
TOTAL	159 (100)	38 (100)	31 (100)	228 (100)

Note:

[1]Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 3b

Tender Offers Accounted for by
Each Target Size and Type of Offer

Target Size ($ million)	Type of Offer*			Total
	Any-or-All	Two-Tier	Pure Partial	
Less than 5m	90%	0%	10%	100%
5m to 10m	65	6	29	100
10m to 50m	78	9	13	100
50m to 100m	78	11	11	100
100m to 500m	64	22	14	100
500m to 1,000m	46	54	0	100
Greater than 1,000m	38%	47%	15%	100%

Note:

*Type of offer is the final form after all amendments to the offer .

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 4a

Average Percent
Blended Premiums by Type of Offer: 1981-1984

Year	Type of Offer*			
	Any-or-All	Two-Tier	Pure Partial	Total
1981	67.9	54.9	15.0	53.9
1982	68.0	53.1	38.4	60.6
1983	60.4	75.8	27.4	59.7
1984	50.7	41.1	12.9	45.7
TOTAL	59.6	54.5	20.1	53.4

Note:

*Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 4b

Average Percent Blended Premiums, by Stage and Negotiation Results of Tender Offers: 1981-1984

Stage and Negotiation Results of Offer

	Initial Offer		Ultimate Offer		
Year	Negotiated	Non Negotiated	Negotiated	Non Negotiated	Total
1981	54.8	53.1	59.8	41.1	53.9
1982	58.0	63.6	58.8	66.2	60.6
1983	57.9	62.6	60.2	57.8	59.7
1984	44.1	48.5	46.2	42.0	45.7
TOTAL	51.7	55.5	54.2	50.2	53.4

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 4c

Average Percent Blended Premiums (Ultimately Received)
by Stage, Type and Negotiation Results of Tender Offers

Type of Offer and Negotiation Results	Stage of Offer: Initial Offer	Stage of Offer: Ultimate Offer
Any-or-All offers:		
Negotiated	52.6	57.3
Non-negotiated	67.5	71.5
Two-Tier Offers:		
Negotiated	58.5	54.6
Non-negotiated	51.9	52.8
Pure Partial Offers:		
Negotiated	18.2	20.6
Non-negotiated	40.2	19.3

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 5

Distribution of Blended Premiums
By Type of Tender Offer
(percents in parentheses)

Average Percent Premium	Type of Offer* Any-or-All	Two-Tier	Pure Partial	Total
less than 0%	3 (2)	1 (3)	3 (10)	7 (3)
0 to 20%	15 (9)	5 (13)	13 (42)	33 (14)
20 to 40%	31 (19)	5 (13)	12 (39)	48 (21)
40 to 60%	46 (30)	15 (40)	2 (6)	63 (27)
60 to 80%	26 (16)	8 (21)	0 (0)	34 (14)
80 to 100%	18 (11)	2 (5)	1 (3)	21 (10)
Greater than 100%	20 (13)	2 (5)	0 (0)	22 (11)
TOTAL	159 (100)	38 (100)	31 (100)	228 (100)

Note:

*Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 6

Average Percent Bid Premiums[1], by Type of Offer: 1981-1984

Year	Type of Offer[2]			
	Any-or-All	Two-Tier	Pure Partial	Total
1981	67.9	68.9	29.2	59.8
1982	68.0	58.8	50.4	63.5
1983	60.4	78.9	50.3	62.2
1984	49.9	49.1	25.8	47.2
TOTAL	59.6	62.8	34.4	56.5

Notes:

[1]The bid premium is the overall premium in any-or-all offers and the first-tier premium in two-tier and pure partial offers.

[2]Type of offer is the final form after all amendments to the offer.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 7

Average Percent First- and Second-Tier Premiums in Two-Tier and Pure Partial Offers: 1981-1984

	TWO-TIER			PURE PARTIAL		
Year	First Tier	Second Tier	Blended Premium	First Tier	Second Tier	Blended Premium
1981	68.9	41.5	54.9	29.2	11.9	15.0
1982	58.8	43.8	53.1	50.4	20.1	38.4
1983	78.9	72.7	75.8	50.3	10.8	27.4
1984	49.1	32.6	41.1	25.8	7.2	12.9
TOTAL	62.8	44.8	54.5	34.4	12.0	20.1

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 8

Distribution of Percent
Differences Between First- and Second-Tier Values, [1]
for Two-Tier and Partial Tender Offers
(percents in parentheses)

Percent of Difference between Tiers	Type of Offers[2] Two-Tier	Partial
Less than 0%	7 (18)	5 (17)
0 - 20%	20 (53)	9 (31)
20 - 40%	3 (8)	7 (24)
40 - 60%	6 (16)	4 (14)
60 - 80%	1 (3)	3 (10)
80 - 100%	1 (3)	0 (0)
Greater than 100%	0 (0)	1 (3)
TOTAL[3]	38 (100)	29 (100)

Notes:

[1]The percent difference in tier values equals:

$$(P_T/P_E) - 1$$

[2]Type of offer is the final form after all amendments to the offer.

[3]Data on several offers are not complete. Offers missing data on a tabulation's key variable are dropped resulting in this table showing fewer observations than other tables.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

TABLE 9

Disposition of Shares in Tender Offers

Percent of Fully Diluted Shares Outstanding

Type of Offer[1] and Negotiation Results	Prior Bidder Holdings[2]	Tendered	Tendered Shares Purchased	Final Bidder Holdings
Any-or-All Offers:				
Negotiated	12%	76%	76%	88%
Non-negotiated	18	57	57	75
Total	13	73	73	86
Two-Tier Offer:				
Negotiated	4	63	45	49
Non-negotiated	5	50	50	55
Total	4	62	46	50
Pure Partial Offers:				
Negotiated	18	50	32	50
Non-negotiated	12	24	17	29
Total	14%	34%	22%	36%

Notes:

[1]Type of offer is the final form after all amendments to the offer.

[2]Prior bidder holdings are comprised of shares held by the bidder prior to the bid and any shares privately purchased outside of the bid.

Source: Office of Chief Economist and Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

Table 10
Tender Offer
Auction Contests for Control
1981-1983

(1) Target	(2) No. of Bidders	(3) No. of Any-or-All Bidders	(4) Winner Was Any-or-All?	(5) Offer With Highest Value Won?	(6) Reason if (5) is "No"
Brookwood Health	2	2	Yes	Yes	
Brunswick	2	0	No	Yes	
Buffalo Forge	2	1	Yes	Yes	
Cities Service	3	0	No	No	July 28, 1982, FTC authorized the issuance of a preliminary injunction of Gulf acquisition. Gulf then abandoned its bid.
Conoco	4	1	No	No	In Nov. of 1981 the Justice Dept issued a preliminary injunction against a Mobil Corp. acquisition of Conoco.
Enstar	2	1	No	No	
Fisher Scientific Corp. a/	2	1	No	Yes	

a/ This is nominally a contest. In April of 1981 a merger proposal was turned down by management. This offer was never made to shareholders. Then in July, when the first offer was long gone, a successful partial tender offer was launched by another firm. The partial offer won, however, it was clearly the better offer.

Table 10
(continued)

(1) Target	(2) No. of Bidders	(3) No. of Any-or-All Bidders	(4) Winner Was Any-or-All?	(5) Offer With Highest Value Won?	(6) Reason if (5) is "No"
General American Oil	3	1	Yes	Yes	
General Steel Industries b/	2	1	Yes	Yes	
Gray Drug Stores	2	1	Yes	Yes	
Gulf Oil	2	1	Yes	Yes	
HMW Industries	2	1	No	Yes	
Interpace	2	1	No	Yes	
Lightolier	2	0	No	Yes	
Manufacturers Bancorp	2	0	No	Yes	
Marathon	3	0	No	Yes	
Means Services Inc.	2	0	No	Yes	
National Mine Service	2	0	No	Yes	
Norton Simon	3	0	No	Yes	

b/ This is another case where an any-or-all beats a partial. However, it should be pointed out that the partial bid ran into legal problems because of prior open market purchases.

Table 10
(continued)

(1) Target	(2) No. of Bidders	(3) No. of Any-or-All Bidders	(4) Winner Was Any-or-All?	(5) Offer With Highest Value Won?	(6) Reason if (5) is "No"
Pabst	4	0	No	Yes	
Property Investors of Colorado	2	1	Yes	Yes	
Richardson	2	1	Yes	Yes	
Standard Coosa Thatcher	2	1	Yes	Yes	
St. Joe Minerals	2	1	Yes	Yes	
Stokely Van Corp	3	1	Yes	Yes	
Sunbeam	2	0	No	Yes	
Texas Gas Resources	2	1	Yes	Yes	
Union Commerce	3	1	Yes	—c/	

c/ In this case Central Bancorp had the highest per share price on its partial offer. However, it lost to Huntington Bankshares' any-or-all offer when the Federal Reserve blocked Central's bid. Since we don't know what Central Bancorp's second tier would have been, and since the offers were otherwise close, it is difficult to determine whether the best offer won.

Sample List

Successful Any & All Cash Tender Offers (1981-1984)

Adams Drug Co., Inc., by Pantry Pride, Inc. (1984)
Aegis Corp., by Minstar Inc. (1984)
Amalgamated Sugar Co., by National City Lines, Inc. (1982)
Amerace Corp., by Raceco (1984)
American Motor Inns, Inc., by Prime Motor Inns, Inc. (1984)
American Sterilizer Co., by Amsco Acquisition Co. (1984)
Americal Welding & Manufacturing Co., by Hoover Universal, Inc. (1982)
Anta Corp., by Manor Care, Inc. (1983)
Associated Coca-Cola Bottling Co., Inc., by Coca Cola Co. (1982)
Atlantic Oil Corp., by Stephens, Inc. (1983)
Avco Corp., by Textron, Inc. (1984)
Bache Group Inc., by Prudential Insurance Co. of America (1981)
Baker Bros., Inc., by Roth Corp. (1982)
Bangor Punta Corp., by Lear Sieglar, Inc. (1983)
Bassett-Walker, Inc., by VF Corp. (1984)
Beck/Arnley Corp., by Guest Keen & Nettlefolds, PLC (1984)
Bekins Co., by Minstar, Inc. (1983)
Belknap, Inc., by David A. Jones (1984)
Buffalo Forge Co., by Ampco-Pittsburgh Corp. (1981)
Burgess Industries, Inc., by Valley Industries, Inc. (1982)
Burns International Security Services, Inc., by Borg-Warner Corp. (1982)
CFS Continental, Inc., by A. E. Staley Mfg. Co. (1984)
CNB Financial Corp., by O.C.I. Bancshares (1984)
Camelot Industries Corp, by Buckbee-Mears Co. (1982)
Cannon Mills Co., by Pacific Holding Corp. (1982)
Caressa, Inc., by AEA Investors, Inc. (1984)
Carnation Co., by Nestle, S.A. (1984)
Carpenter Paper Co., by Alco Standard Corp. (1981)
Cenco, Inc., by Manor Care, Inc. (1981)
Cenvill Development Corp., by First American Bank & Trust of North Palm Beach (1984)
Children's World, Inc. by Grand Metropolitan, Ltd. (1983)
Clausing Corp., by Rexnord, Inc. (1984)
Compugraphic Corp., by Bayer AG (1981)
Connecticut General Mortgage & Realty Investments, by Prudential Insurance Co. of America (1981)
Contech, Inc., by Rexnord, Inc. (1982)
Conwed Corp., by Cardiff Equities Corp., an affiliate of Leucadia National Corp. (1984)
Core Laboratories, Inc., by Litton Industries, Inc. (1984)
Criton Corp., by Dyson-Kissner-Moran Corp. (1982)
DSI Corp., by Anacomp, Inc. (1982)
Danly Machine Corp., by Ogden Corp. (1981)
Datatab, Inc., by Data Probe, Inc. (1983)
Delhi International Oil Corp., by CSR Ltd. (1981)
Donaldson, Lufkin & Jenrette, Inc., by the Equitable Life Assurance Society of the U.S. (1984)

Successful Any & All Cash Tender Offers (1981-1984) (cont.)

Dorchester Gas Corp., by Damson Oil Corp. (1984)
Electro-Protective Corp. of America, by Hawley Group Ltd. (1981)
Energy Reserves Group, Inc., by The Broken Hill
Proprietary Co., Ltd. (1984)
Erickson Corp, by Lull Eng. Corp. (1981)
Esmark, Inc., by Beatrice Foods Co. (1984)
Fabri-Tek, Inc., by CTS Corp. (1982)
Fairfield-Noble Corp., by Lloyd Williams, Inc. (1981)
Financial General Bankshares, Inc., by Credit &
Commerce American N.V. (1982)
First Marine Banks, Inc., by Barnett Banks of Florida, Inc. (1981)
First National Lincoln Corp. by Omaha National Corp. (1983)
Flickinger (S.M.) Co., Inc., by Scrivner, Inc. (1984)
Florida Coast Banks, Inc., by Barnett Banks of
Florida, Inc. (1984)
Flower Time, Inc., by General Host, Inc. (1984)
Formigli Corp., by High Industries, Inc. (1982)
Frank's Nursery & Crafts, Inc., by General Host Corp. (1983)
Garfinkel, Brooks Brothers, Miller & Rhoads, Inc.,
by Allied Stores Corp. (1981)
Gas Service Co., by Kansas Power & Light Co. (1983)
General Portland Inc., by Canada Cement Lafarge Ltd. (1981)
Getty Oil Co., by Texaco, Inc. (1984)
Giddings & Lewis, Inc., by Amca International Corp. (1982)
Gino's, Inc., by Marriott Corp. (1982)
Grand Central, Inc., by FMI Associates (1984)
Graniteville Co., by Southeastern Public Service Co. (1983)
Gray Drug Stores, Inc., by Sherwin-Williams Co. (1981)
Gulf Corp., by Standard Oil Co. of California (1984)
Hawkeye National Insurance Co., by
Gan Vie, Cie Francaise D'Assurance sur la vie. (1981)
Higbee Co., by Industrial Equity (Pacific) Ltd. (1984)
Hobart Corp., by Dart & Kraft, Inc. (1981)
Impell Corp., by Combustion Engineering, Inc. (1984)
Intermountain Gas Industries, Inc., by IMG Holdings, Inc. (1984)
Itek Corp., by Litton Industries, Inc. (1983)
James (Fred S.) & Co., Inc., by Transamerica Corp. (1982)
Jamesbury Corp., by Combustion Engineering, Inc. (1984)
Jetero Corp., by Beeler-Sanders Inc. (1982)
Juniper Petroleum Corp., by Damson Oil Corp. (1982)
Kentucky-Tennessee Clay Co., by
Ranchers Exploration & Development Corp. (1983)
King James Corporation, by Manor Care, Inc. (1984)
Lane Bryant, Inc., by Limited Stores, Inc. (1982)
Leader Healthcare Organization, Inc., by Cenco, Inc. (1981)
Lenox, Inc., by Brown-Forman Ltd. (1983)
Lightolier, Inc., by Bairnco Corp. (1981)
Love Petroleum Co., by U.S. Energy Search, Inc. (1981)
Ludlow Corp., by Tyco Laboratories, Inc. (1981)
Magma Power Co., by Natomas Co. (1981)
Malone & Hyde, Inc., by Pittco Acquisition Corp. (1984)
Marshall Field & Co., by B.A.T. Industries PLC. (1982)
Masonite Corp., by United States Gypsum Co. (1984)

Successful Any & All Cash Tender Offers (1981-1984) (cont.).

Means Services, Inc., by ARA Services (1982)
Medford Corp., The Amalgamated Sugar Co. (1984)
Mesa Royalty Trust, by Mesa Petroleum Co. (1984)
Michigan Sugar Co., by Savannah Foods & Industries, Inc. (1984)
Mid States Holding Co., by American Insurance Management Co., Inc. (1984)
Miller Bros. Industries, Inc., by Miller Bros. Holdings, Inc. (1984)
Miller-Wohl Co., Inc., by Petrie Stores Corp. (1984)
Mississippi Valley Gas Co., by Yazoo Investment Corp. (1984)
Monarch Tile Manufacturing Co., by Societe Chimigue Routiere S.A. (1981)
National Mobile Concrete Corp., by Chaucer Alliance, Inc. (1982)
National Savings Corp., by Western Preferred Corp. (1982)
New Mexico Financial Corp., by Delwin W. Morton & Charles J. Wilson (1983)
Northwest Energy Co., by Williams Companies (1983)
Northwestern Mutual Life Mortgage & Realty Investors, by Northwestern Mutual Life Insurance Co. (1982)
Norton Simon, Inc., by Esmark, Inc. (1983)
Pabst Brewing Co., by S&P Co., Inc. (1984)
Page Airways, Inc., by Guthrie Corp. Ltd. (1981)
Pargas, Inc., by Reliance Group Holdings, Inc. (1983)
Parson's Corp., by E.S.O.P. (1984)
Pay'N Save Corp., by The Trump Group, Ltd. (1984)
Peoples Drug Stores, Inc., by Imasco, Ltd. (1984)
Petrolane, Inc., by Texas Eastern Corp. (1984)
Prairie Producing Co., by Placer Development, Ltd. (1984)
Prentice-Hall, Inc., by Gulf & Western Industries, Inc. (1984)
Puritan Fashions Corp., by Calvin Klien (1983)
Qonaar Corp., by Kroehler Manufacturing Co. (1981)
Rampac, by Pan-American Properties, Inc. (1983)
Rand Capital Corp., by Crossbill Inc. (1982)
REDM Industries, Inc., by Pullman Transportation Co., Inc. (1984)
RSR Corp., by RSR Holding Corp. (1984)
Reliance Universal, Inc., by Tyler Corp. (1981)
Richardson Co., by Witco Chemical Corp. (1981)
Rio Grande Industries, Inc., by The Anschutz Corp. (1984)
Roper Industries, Inc., by Dexter Corp. (1981)
SCA Services, Inc., by Waste Management, Inc. and Grenstar Corp. (1984)
SSP Industries, by TransTechnology Corp. (1983)
Sav-a-Stop, Inc., by Consolidated Foods Corp. (1982)
Schrader (Abe) Corp., by Interco, Inc. (1984)
Security National Life Insurance Co. of Puerto Rico, by Puerto Rican-American Corp. (1984)
Sonoma Vineyards, by Renfield Corp. (1984)
Stecher-Traung-Schmidt Corp., by International Paper Co. (1983)
Stokely-Van Camp Inc., by Quaker Oats Co. (1983)
Strother Drug Co., by Alco Standard Corp. (1981)
Suburban Propane Gas Corp., by National Distillers & Chemical Corp. (1983)

Successful Any & All Cash Tender Offers (1981-1984) (cont.)

Super Dollar Stores, Inc., by Variety Wholesalers (1981)
Tano Corp., by Rexnord, Inc. (1984)
TFI Companies, Inc., (now Cardiff Equties)
by Leucadia National Corp. (1982)
Technicolor, Inc., by MacAndrews & Forbes Group, Inc. (1982)
Telerent Leasing Corp., by Aviation Group, Inc. (1984)
Texas Gas Resources Corp., by CSX Corp. (1983)
Texasgulf, Inc., by Societe Nationale Elf Aguitaine (1981)
Torin Corp., by Clevepak Corp. (1982)
Treadway Companies, Inc., by Fair Lanes, Inc. (1981)
Tri-American Corp., by Scottish & York Holdings Ltd. (1981)
Tribune Oil Corp., by Sabine Corp. (1983)
Tymshare, Inc., by McDonnell Douglas Corp. (1984)
Union Electric Steel Corp., by Ampco-Pittsburg Corp. (1984)
Union Gas Systems, Inc., by Z. G. Transitory Corp. (1984)
United Realty Investors, Inc., by Butterfield Savings &
Loan Association (1983)
United States Equity & Mortgage Trust, by Real Estate
Investment Properties (1984)
United States Industries, Inc., by Hanson Trust, PLC (1984)
United States Sugar Corp. by E.S.O.P. (1983)
Volume Merchandise, Inc., by VM Acquisition Corp. (1984)
Vulcan, Inc., by Ampco-Pittsburg Corp. (1984)
Walter Realty Investors, Inc., by Seville Corp. (1981)
Western Gear Corp., by Bucyrus-Erie Co. (1981)

Successful Two-Tier Cash Tender Offers (1981-1984)

Belco Petroleum Corp., by Internorth, Inc. (1983)
Bendix Corp., by Martin Marietta Corp. (1982)
Breeze Corporations, Inc., by TransTechnology Corp. (1982)
Bunker Ramo Corp., by Allied Corp. (1981)
Chem-Nuclear Systems, Inc., by Waste Management, Inc. (1982)
Cities Service Co., by Occidental Petroleum Corp. (1982)
Coldwell, Banker & Co., by Sears, Roebuck & Co. (1981)
Conoco, Inc., by Du Pont (E.I.) De Nemours & Co. (1981)
Continental Airlines Corp., by Texas Air Corp. (1981)
Data Terminal Systems, Inc., by National
Semi-Conductor, Inc. (1983)
Dean Witter Reynolds Organization, Inc., by Sears &
Roebuck and Co. (1981)
El Paso Co., by Burlington Northern, Inc. (1982)
Electronic Modules Corp., by Rexnord Inc. (1984
Enstar Corp., by Allied Corp. and Ultramar, PLC (1984)
Fisher Scientific Co., by Allied Corp. (1981)
HMW Industries, Inc. by Clabir Corp. (1983)
Heublein, Inc., by Reynolds (R.J.) Industries, Inc. (1982)
Instrumentation Laboratory, Inc., by Allied Corp. (1983)
Interpace Corp., by Clevepak Corp. (1983)
Jewel Companies, Inc., by American Stores Corp. (1984)
Jonathan Logan, Inc., by United Merchants &
Manufacturers, Inc. (1984)
Kent-Moore Corp., by Sealed Power Corp. (1981)
Mallinckrodt, Inc., by Avon Products, Inc. (1981)

Successful Two-Tier Cash Tender Offers (1981-1984) (cont.)

Manufacturers Bancorp, Inc., by Ameribanc, Inc. (1983)
Marathon Oil Co., by United States Steel Corp. (1981)
Martin Marietta Corp., by Bendix Corp. (1982)
Midlands Energy Co., by Freeport-McMoRan, Inc. (1984)
Milton Bradley Co., by Hasbro-Industries, Inc. (1984)
Narco Scientific, Inc., by Healthdyne, Inc. (1982)
Olympia Brewing Co., by Pabst Brewing Co. (1982)
Pabst Brewing Co., by G. Heileman Brewing Co. (1982)
St. Joe Minerals Corp., by Fluor Corp. (1981)
St. Regis Corp., by Champion International Corp. (1984)
Schlitz (Jos.) Brewing Co., by Stroh Brewing Co. (1982)
Sta-Rite Industries, Inc., by Wicor, Inc. (1982)
Sunbeam Corp., by Allegheny International, Inc. (1981)
Supron Energy Corp., by Allied Corp. (1982)
Thiokol Corp., by Morton-Norwich Products, Inc. (1982)
Wallace-Murray Corp., by Household International, Inc. (1984)

Successful Partial Cash Tender Offers (1981-1984)

Applied Solar Energy Corp., by Stauffer Chemical Co. (1984)
Brunswick Corp., by American Home Products Corp. (1982)
Cedar Point, Inc., by S. Pearson & Son, Ltd. (1981)
Chesapeake Life Insurance Co., by Lifeshares of
Nebraska, Inc. (1981)
Chieftain Development Co., Ltd., by
Alberta Energy Co. Ltd. (1982)
Conoco, Inc., by Dome Petroleum, Ltd. (1981)
Conoco, Inc., by Seagram Co. Ltd. (1981)
Dan River, Inc., by Ichan Capital Corp. (1982)
Faberge, Inc., by McGregor, Inc. (1984)
First Maryland Bancorp by Allied Irish Banks, Ltd. (1983)
Florida Commercial Banks, Inc., by Hugh Culverhouse (1984)
G.F. Business Equipment, Inc., (now GF Corp.) by
Anderson Equity Investments (1982)
General Steel Industries, Inc., by Walco National Corp. (1981)
Hamilton Oil Corp., by AB Volvo (1984)
Harsco Corp., by Crane Co. (1981)
Life Investors, Inc., by AGO International B.V. (1981)
Mission Insurance Group, Inc., by American Financial Corp. (1984)
National Mine Service Co., by Anderson Strathclyde PLC (1983)
Opelika Manufacturing Corp., by Technical Equipment
Leasing Corp. (1981)
Pier 1 Imports, Inc., by Fugua Industries, Inc. (1981)
Phone-Mate, Inc., by Asahi Corp. (1984)
Pogo Producing Co., by Sedco, Inc. (1983)
Property Investors of Colorado by DBP Partners (1981)
Real Estate Investment Trust of America by San Francisco
Real Estate Investors (1982)
Salem Financial Corp., by Salem Capital Corp. (1983)
Southside Bancshares Corp., by E.S.O.P. (1984)
Speed-o-print Business Machines Corp., by Peter
Nisselson, et al. (1984)
Terrydale Realty Trust by BCG Associates (1981)
USP Real Estate Investment Trust by Life Investors (1981)
USP Real Estate Investment Trust by Minneapolis Investors (1981)

EXHIBIT B

A Study

by

The Office of the Chief Economist
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

April 19, 1985

Institutional Ownership, Tender Offers, and Long-Term Investments

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The views expressed herein are those of the Office of the Chief Economist only. The Commission has expressed no view on this study.

Institutional Ownership, Tender Offers, and Long-Term Investments

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One of the principal arguments made by critics of hostile tender offers is that the threat of a hostile tender offer preoccupies corporate executives with propping up short-term earnings, at the expense of investing in long-term projects, such as research and development. 1/ Although this argument, hereafter referred to as the "short-term argument", has attracted a sympathetic audience, no evidence has yet been advanced in its support. This study empirically examines the argument and concludes that it is not supported by statistical evidence presented here.

The Short-Term Argument

Central to the short-term argument is the observation that institutional investors (e.g., pension funds, mutual funds) have come to dominate the ownership of corporate equity. In contrast to the traditional individual shareholder, it is argued that institutional investors have short-time horizons, and regularly "churn" their portfolios. This proclivity to churn supposedly derives from two sources: the fiduciary responsibility of fund managers, and the intensely competitive market for money managers that results in quarter-to-quarter monitoring of their performance.

This behavior of large institutional shareholders purportedly facilitates hostile tender offers - institutional investors

stand ready to tender their shares to any bidder offering even a small premium over market price. To stave off hostile takeover attempts, corporate managers supposedly try to prop up stock prices by increasing short-term earnings, even at the expense of abandoning otherwise profitable long-term investment projects in which present expenditures are incurred in anticipation of future earnings. According to proponents of the short-term argument, this induced myopia is ubiquitous among corporate executives and it is eroding our country's ability to compete in the international economy. 2/

On conceptual grounds, many economists are critical of the short-term argument. 3/ Implicit in the short-term argument is the view that the capital market systematically undervalues expected earnings. The argument assumes that investors are persistently fooled by firms that reduce expenditures on economically viable long-term investment projects in order to inflate present earnings. Economists argue that the arbitrage possibilities presented by systematic mispricing of securities creates strong financial incentives for self-correction in the stock market. This occurs as sophisticated investors bid up (down) the price of undervalued (overvalued) securities until the price of a security equals an unbiased estimate of its "true" value. The economists' view does not deny that under some circumstances, corporate managers may have incentives to artifically inflate earnings in ways that are costly for investors to monitor. Inflating

short-term earnings by reducing expenditures on otherwise profitable investment projects, however, is too visible, particularly to sophisticated investors such as institutional funds. Firms that followed this practice, according to these economists, would unfavorably affect their stock price, thereby rendering this strategy ineffective in staving off hostile tender offers.

Although economists have not directly examined the relationship between institutional ownership, hostile tender offers, and investment in long-term projects, there is an abundance of indirect evidence that is inconsistent with the short-term argument. There is, for example, considerable stock price evidence showing that the market effectively values time-discounted cash flows, not simply current reported earnings. For example, the market does not devalue companies that switch their inventory valuation from first-in, first-out (FIFO) to last-in, first-out (LIFO), even though this accounting change is supposed to reduce reported earnings during periods of positive inflation rates. 4/ Also, the fact that price-earnings ratios vary widely across firms indicates that the market does discriminate in assessing the future prospects of firms. 5/ In addition, received wisdom holds that the principal sources of financing for venture capital firms are institutional investors, which seems to damage the argument that institutional investors are attracted only to firms with relatively high short-term earnings.

Testable Implications of the Short-Term Argument

Besides this abundance of indirect evidence, which is inconsistent with the short-term argument, no evidence that directly addresses the short-term argument has yet been presented by either its proponents or its critics. 6/ Given the profound implications of accepting this argument, it is important that it be subjected to rigorous empirical testing. In our view, the short-term argument has the following testable implications:

- An inverse relationship should exist between the percentage of a firm's equity held by institutional investors and the level of the firm's investment in long-term projects, such as R&D (i.e., the greater the institutional holdings, the lower is R&D).
- Target firms in tender offers should exhibit high spending on long-term investment projects relative to their past experience, and relative to other firms in the same industry
- The percentage of equity held by institutional investors in target firms of tender offers should be higher than the corresponding figure for non-target firms in the same industry, preceding their takeover.
- The public announcement by firms that they are embarking on a new long-term investment project should result in a negative stock price reaction, reflecting the market's expectation that short-term earnings will be adversely affected.

The remainder of this study reports the results from an empirical investigation of these and related implications of the short-term argument.

Empirical Results

Institutional Holdings and Investments in R&D

The short-term argument makes a testable prediction

about the relationship between the percentage of a firm's equity held by institutions and its investment in long-term projects. Since this argument states that the growth of institutional ownership is inducing myopia among corporate executives, we should observe relatively low (high) investment in long-term projects by companies having a large (small) percentage of equity held by institutions.

To examine the relationship between institutional ownership of corporate equity and investment in long-term projects, we collected data for 324 firms representing a cross section of industries including aerospace, appliances, automobiles, chemicals, drugs, electrical, fuel, information processing, instruments, leisure, farm machinery, paper, personal and home care products, semiconductors, steel, telecommunications, food and beverages, and tires and rubber. This sample consists of all firms in these industries which were listed in the Business Week "R&D Scoreboard" for each of the years, and for which we were able to obtain data on institutional ownership. For each of these firms we collected the following data for each of years 1980-1983: the percentage of common equity held by institutions that report to the SEC under Rule 13F (i.e., institutional funds with combined equity assets in excess of $100 million), total revenues, net income before extraordinary items or discontinued operations, and company sponsored R&D expenditures, which is our proxy for the companies' investment in long-term projects. The firms vary

widely in size, ranging from Gelman Sciences with 1983 revenues of $40 million to Exxon with 1983 revenues of $89 billion.

In short, these data tend to refute the short-term argument. Table 1 shows that institutional ownership, as a percentage of common equity, has steadily increased from an average of 30.0 in 1980 to 38.0 in 1983. Concomitant with this increase has been a steady increase in the average ratio of R&D to revenues, from 3.38% in 1980 to 4.03% in 1983. In the aggregate, then, institutional ownership has been increasing, but there is no evidence that corporate managers have become increasingly myopic by investing more in short-term projects. Indeed, the opposite is true, according to these data.

Since the level of a firm's R&D expenditures is determined by many factors, it is useful to probe behind the aggregate data to detect the incremental impact of institutional ownership on R&D expenditures. Table 2 contains results from estimation of a regression equation in which the average R&D to revenues ratio (1980-1983) for each of the firms is regressed on: i) the average percentage of equity held by institutional investors in the firm over the same period, and ii) a series of industry dummy variables. These results reveal, holding industry effects constant, that there is a direct and statistically significant relationship between institutional ownership and R&D expenditures. This means that the higher the institutional holdings in a firm, the higher is its R&D activity. Although these results do not establish that higher institutional

ownership causes high R&D expenditures, they do strongly suggest that institutional investors are not deterred from investing in firms with high R&D expenditures.

The causal relationship between institutional ownership and R&D expenditures can be investigated empirically by examining what happens to R&D expenditures in firms that experience changes in the percentage of its equity held by institutional investors. In many of the 324 firms in our sample, there were sizeable changes in the percentage of equity held by institutions, ranging from a decline of 29 percentage points in Mattel to an increase of 48 percentage points in Outboard Marine. The short-term argument predicts that companies such as Outboard Marine will become more vulnerable to hostile takeovers. As a result, these companies will become increasingly more preoccupied with short-term earnings, which should manifest itself in reductions in R&D expenditures. By the same logic, companies experiencing substantial reductions in institutional ownership will feel less threatened by a hostile takeover, which should result in an increase in their R&D expenditures.

Tables 3 and 4 list results which contradict the prediction of the short-term argument. In Table 3, we list the average changes in the ratio of R&D outlays to sales from 1980 to 1983 for firms that experienced a decline in institutional ownership and for groups of firms that experienced progressively larger increases in institutional ownership. The average

change in R&D-sales ratio for the firms experiencing a decline in institutional ownership was 0.67%. The corresponding change for firms experiencing an increase in institutional ownership was almost identical, 0.65%. Furthermore, no discernible pattern in R&D changes exists among firms with increasingly larger positive changes in institutional holdings.

Table 4 contains regression results from an equation in which the change in R&D-revenue ratio for each of the 324 firms is regressed on the change in institutional holdings and a set of industry dummy variables. These results indicate that a positive, but statistically insignificant relationship exists between changes in institutional holdings and changes in R&D expenditures. In short, Tables 3 and 4 do not provide empirical support for the argument that an increase in institutional ownership causes corporate managers to become myopic.

R&D Activity and Institutional Ownership in Target Firms of Tender Offers

Another testable proposition of the short-term argument is the contention that firms which invest in long-term projects will suffer declines in the market value of their equity, and possibly a takeover. This proposition implies that R&D expenditures in target firms of tender offers should be high relative to the firm's past experience and relative to an industry control group of nontarget firms.

To test this proposition, we consulted the pre-tender offer, 10-K reports of all target firms in successful tender offers during

the period 1981-1984. Of the 217 target firms in this sample, 160 firms reported that their R&D expenditures were "not material". This high percentage of actual targets not reporting material R&D outlays ssuggests that it is incorrect to identify actual targets with intensive R&D activity. For the remaining 57 firms in the sample having material R&D outlays, we calculated the R&D-to-revenue ratio in the year immediately preceding the tender offer, and in the three prior years. For the same years, we also calculated these ratios for the industries in which these firms competed.

Table 5 shows that, contrary to the short-term argument, the value weighted R&D-revenue ratio for target firms, 0.77%, was less than one-half that of the industry control groups, 1.66%, in the year immediately preceding the tender offer. Furthermore, these data were not significantly different from the corresponding data in the three previous years: 0.75% for target firms and 1.49% for the industry control groups. These data strongly suggest that investment in long-term projects such as R&D does not make a firm vulnerable to takeovers.

We caution, however, against drawing tne tempting inference that target firms typically "underinvest" in R&D. As Table 6 shows, these target firms were significantly smaller than their industry counterparts. Median revenue for the 57 target firms in the year immediately preceding the tender offer was $312 million, as compared with a corresponding median of $1382.6 million for the industry control groups. Similarly, the average revenue for

the two sets of firms was $1731.5 million and $2592.1 million, respectively. To the extent that economies of scale exist in R&D, which is a common and sensible belief, it is natural to expect smaller firms to have smaller R&D-revenue ratios than larger firms. Nonetheless, the data do not support the proposition that target firms tend to "overinvest" in R&D projects.

The short-term argument also predicts that institutional ownership in target firms is higher than institutional ownership in nontarget firms. Table 7 lists the average percentage of equity held by institutional investors (that report to the SEC under 13F) in 177 target firms (1981-1984) in the quarter immediately preceding the tender offer. Also listed is the corresponding average for 177 industry control groups. The data show that institutional ownership in the target firms, 19.3%, was actually lower, than it was, 33.7%, in the industry control groups. Given that target firms typically are smaller than their industry counterparts, this difference may be attributed to size differences. These data do, however, suggest that it is not high institutional ownership *per se* that fuels tender offers.

Stock Price Reaction to R&D Announcements

Finally, the short-term argument unambiguously predicts that the stock market devalues firms which invest in projects that impair their short-term earnings, even if these projects have a positive net present value. To test this prediction, we examined

the stock price reaction to 62 Wall Street Journal announcements that firms were embarking on an R&D project. These announcements were collected by instructing NEXIS, the news retrieval system, to provide us with all Wall Street Journal articles containing the words "research and developent" during the period 1973-1983. Using the conventional event study methodology, 7/ we estimated the net-of-market stock returns to shareholders of the 62 firms around the date on which they announced their R&D projects.

Table 8 contains the results from this experiment. On the announcement day, Day 0, these firms experienced an average abnormal return of positive 0.45%, followed by an additional 0.35% abnormal return on the next trading day. The two-day announcement return of 0.80% is statistically significant (t-statistic = 2.5) and represents a substantial net-of-market increase in the value of the firm's equity. During the 20 trading days after the announcement, the cumulative net-of-market return increases to 1.8%.

This evidence strongly refutes the proposition that the stock market values only short-term earnings, and not expected future earnings. A logical inference to be drawn from this evidence is that it is futile for corporate managers to try to forestall a hostile takeover by pumping up short-term earnings at the expense of investing in long-term projects with positive net present values.

Conclusion

The evidence reported in this study uniformly contradicts the short-term argument. This evidence shows:

- For a sample of 324 firms in a diverse set of industries, the percentage of equity held by institutional investors (that report to the SEC under Rule 13f) increased from 30% in 1980 to 38% in 1983. During this same period, the average R&D-revenue ratio for these firms also increased from 3.38% to 4.03%. These aggregate data do not support the argument that the growth in institutional ownership of corporate equity is forcing corporate managers to become more myopic. (See Table 1.)

- Regression analysis reveals that, holding industry effects constant, institutional investors actually seem to favor firms with high R&D-revenue ratios. (See Table 2.)

- In our sample of 324 firms, 88 firms experienced a decline in institutional ownership during this period and 236 firms experienced an increase in institutional ownership. The average change in R&D-revenue ratio for the two groups of firms, however, was almost identical - 0.67% for the former group and 0.65% for the latter group. These data refute the argument that increases in institutional ownership cause managers to focus more on the short-term. (See Table 3.)

- Regression analysis reveals that, holding industry effects constant, changes in institutional holdings are not correlated with changes in R&D activity. (See Table 4.)

- Examination of data on R&D expenditures for 57 target firms (1981-1984) reveals that these firms had an average R&D-sales ratio, 0.77%, which was less than one-half of that, 1.66%, for an industry control group in the year immediately preceding the tender offer. These data strongly suggest that investment in long-term projects does not increase a firm's vulnerability to a takeover. It is also noteworthy that an additional 160 target firms during this period reported (in their 10-K's) that their R&D expenditures were "not material". We caution against drawing the inference that

these firms became vulnerable to a takeover because they were underinvesting in R&D activity. Target firms are smaller than their industry counterparts, and to the extent there are economies of scale in R&D, it is natural to find lower R&D-sales ratios for target firms. (See Table 6.) In addition, the target firms' R&D-revenue ratio in the year immediately preceding the tender offer is not significantly different from the corresponding ratio, 0.75%, in the previous three years.

- The average percentage of equity held by institutional investors in 177 target firms (1981-1984) for which we were able to obtain ownership data was 19.3% in the quarter immediately preceding the tender offer, as compared with a corresponding average of 33.7% for firms in an industry control group of nontarget firms. These data seem to contradict the assertion that heavy institutional ownership *per se* gives rise to hostile takeovers. (See Table 7.)

- Stock price evidence reveals that the capital market positively values companies that announce that they are embarking on an R&D project. The net-of-market increase in the equity value of 62 firms making such announcements (1973-1983) was 0.80% over the two days following the announcement, and this increase is statistically significant. This evidence rebukes the argument that the market penalizes companies that invest in long term projects and thereby makes them candidates for - hostile takeovers.

Collectively, this evidence seems to refute the short-term argument. We welcome comments and suggestions for improving the study from both proponents and critics of this argument.

FOOTNOTES

1/ This argument has appeared frequently in the business press, including "Andrew Sigler: Rules for the Takeover Game", Financier (March 1985), pp. 15-20; Peter Drucker, "Taming the Corporate Takeover", Wall Street Journal (October 30, 1984); Allan Sloan, "Why is No One Safe?", Forbes (March 11, 1985), pp. 134-140; "Will Money Managers Wreck the Economy?", Business Week (August 13, 1984), pp. 86-91. This argument also has surfaced in Congressional proposals to regulate hostile takeovers. See, for example, Martin Lipton's proposal, "The Shareholder Protection and Elimination of Takeover Abuses Act of 1985", November 20, 1984.

2/ Proponents of the short-term argument frequently contend that takeover fear is eroding our competitive position vis-a-vis Japan. Interestingly, however, the percentage of equity owned by institutional investors in Japan has increased significantly during the past 32 years from 38.6% in 1980 to 71.9% in 1982. (Source: Securities Markets in Japan 1984 (Tokyo: Japanese Securities Research Institute), 1983) One scholar even attributes the farsightedness of corporate management in purported Japan to the dominant ownership position of institutional investors: "In Japan, where virtually all equity is held by banks and large investment firms, the concern for short-term performance is not nearly as acute for longer-term prospects. As a result, Japanese firms are not as concerned as Western firms about short-term profits or, for that matter, profits in general." (See C. Carl Pegels, Japan vs. the West (Kluwer-Nijhoff), 1984.)

3/ See, for example, the testimony of Professors Harold Demsetz, Michael Bradley, and Michael Jensen in the transcript for the SEC Economic Forum on Tender Offers, February 20, 1984.

4/ See, for example, Shyam Sunder, "Stock Price and Risk Related to Accounting Changes in Inventory Valuation", Journal of Accounting Research (April 1975), pp. 305-313.

5/ These points were made by the economists at the SEC Economic Forum on Tender Offers, February 20, 1985. See footnote 3.

6/ Preliminary findings from this empirical inquiry were sent to SEC Chairman John S.R. Shad in two memos, dated January 22, 1985 and February 20, 1985.

7/ For a discussion of this methodology, see William Schwert, "Using Financial Data to Measure Effects of Regulation", Journal of Law and Economics (April 1981), pp. 121-158.

TABLE 1

Average Institutional Holdings (As Percent of Common Equity) and Average R&D/Revenue for 323 Corporations, 1980-1983

	Average Institutional Holdings	Average R&D Expenditures As Percentage of Revenue
1980	30.0	3.38%
1981	31.2	3.58
1982	34.3	3.98
1983	38.0	4.03

TABLE 2

OLS Estimate of Average R&D/Revenue, 1980-1983, as Function of Average Institutional Holdings, and Industry Variables
(t-statistics in parentheses)

Intercept	0.03
	(6.6)
Institutional Holdings	0.0002
	(2.9)
Chemicals	-0.01
	(2.4)
Drugs	0.04
	(5.7)
Aerospace	-0.005
	(0.7)
Appliances	-0.02
	(2.2)
Automobiles	-0.005
	(0.4)
Leisure	-0.009
	(1.1)
Fuel	-0.04
	(4.4)
Paper	-0.03
	(4.0)
Steel	-0.03
	(2.3)
Electrical	-0.03
	(3.9)
Home Care	-0.02
	(2.3)
Tires and Rubber	-0.03
	(2.7)
Instruments	0.003
	(0.7)
Hi Tech*	0.02
	(4.5)
Food	-0.02
	(3.9)
N	324
R^2	0.41
F	13.1

*HiTech includes information processing, office equipment, semiconductors and telecommunications.

TABLE 3

Average Change in Institutional Holdings (as Percent of Common Equity), 1980-1983 and Average Change in R&D/Revenue, 1980-1983 for Firms with Negative and Increasingly Positive Changes in Institutional Holdings

Group of Firms	Average Change in Institutional Holdings 1980-1983	Average in R&D as Percentage of Revenue, 1980-1983
88 Firms with a Decline in Institutional Holdings	-5.53	0.67%
236 Firms with Increase in Institutional Holdings	13.02	0.65
79 Firms with Smallest Increase in Institutional Holdings	3.84	0.89
77 Firms with Median Increase in Institutional Holdings	10.67	0.41
80 Firms with Largest Increase in Institutional Holdings	24.33	0.64

TABLE 4

OLS Estimate of Change in R&D/Revenue, 1980-1983 as Function of Change in Institutional Holdings, 1980-1983 and Industry Variables (t-statistics in parentheses)

Intercept	0.006
	(2.3)
Change in Institutional Holdings	0.00005
	(0.6)
Chemicals	-0.0008
	(0.2)
Drugs	0.01
	(2.9)
Aerospace	-0.0002
	(0.0)
Appliances	-0.005
	(0.8)
Automobiles	-0.01
	(1.6)
Leisure	0.001
	(0.2)
Fuel	-0.005
	(0.9)
Paper	-0.005
	(1.0)
Steel	-0.003
	(0.4)
Electrical	-0.002
	(0.5)
Homecare	-0.004
	(0.9)
Tires and Rubber	-0.0008
	(0.1)
Instruments	0.0009
	(0.3)
HiTech*	0.003
	(1.1)
Food	-0.002
	(0.5)
N	324
R^2	0.07
F	1.4

*Hi Tecn includes information processing, office equipment, semiconductors, and telecommunications.

TABLE 5

R&D as Percentage of Revenue for 57 Target Firms and their Industry Groups in Year Prior to Tender Offer and the Three Previous Years

Group of Firms	R&D as Percentage of Revenue in Year Preceding Tender Offer	R&D as Percentage of Revenue During Previous Three Years
Target Firms	0.77%	0.75%
Industry Group	1.66	1.49

TABLE 6

Median Revenue and Average Revenue in Year Prior to Tender Offer for 57 Target Firms and Their Industry Groups

Group of Firms	Median Revenue in Year Preceding Tender Offer (in millions)	Average Revenue in Year Preceding Tender Offer (in millions)
Target Firms	$ 312.0	$1731.5
Industry Group	1382.6	2592.1

TABLE 7

Percentage of Equity Held by 13f Institutions in 177 Target Firms of Tender Offers and Their Industry in Quarter Prior to Tender Offer

Group of Firms	Average Percentage of Equity Held by 13f Institutions
Target Firms	19.3%
Industry Group	33.7

TABLE 8

Abnormal Returns of NYSE and Amex Listed Companies that Announced Research and Development Budget/Centers During January 1, 1973 through December 31, 1983. Event Day 0 is the announcement day.

Event Day	Daily Abnormal Return	Cumulative Daily Abnormal Return	Percent Negative	Number of Firms
-20	0.10	0.10	50.0	62
-19	-0.27	-0.17	64.5	62
-18	0.14	-0.03	51.6	62
-17	-0.23	-0.25	50.0	62
-16	-0.18	-0.43	45.2	62
-15	0.12	-0.32	56.5	62
-14	0.03	-0.29	53.2	62
-13	-0.08	-0.37	58.1	62
-12	0.33	-0.04	53.2	62
-11	-0.70	-0.74	61.3	62
-10	-0.24	-0.98	62.9	62
-9	0.03	-0.95	48.4	62
-8	-0.50	-1.45	59.7	62
-7	0.11	-1.35	51.6	62
-6	0.07	-1.27	51.6	62
-5	-0.18	-1.45	59.7	62
-4	0.37	-1.08	37.1	62
-3	0.37	-0.71	43.5	62
-2	-0.10	-0.81	61.3	62
-1	-0.29	-1.10	58.1	62
0	0.45	-0.65	37.1	62
1	0.35	-0.30	46.8	62
2	0.31	0.02	46.8	62
3	-0.01	0.01	45.2	62
4	0.09	0.10	45.2	62
5	0.36	0.46	50.0	62
6	-0.15	0.31	48.4	62
7	0.29	0.60	43.5	62
8	0.12	0.72	50.0	62
9	0.26	0.97	54.8	62
10	0.29	1.26	41.9	62
11	0.38	1.65	45.2	62
12	0.14	1.79	51.6	62
13	0.16	1.95	50.0	62
14	-0.02	1.93	50.0	62
15	0.26	2.19	48.4	62
16	0.15	2.34	46.8	62
17	-0.27	2.07	51.6	62
18	-0.31	1.76	58.1	62
19	0.09	1.86	53.2	62
20	-0.05	1.80	51.6	62

EXHIBIT C

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE CHIEF ECONOMIST

OFFICE OF THE CHIEF ECONOMIST

May 17, 1985

RE : Update -- "Shark Repellent" Antitakeover Charter Amendments

From 1979 through 1984, shareholders of over 450 firms approved charter amendments which would make it more difficult for changes in corporate control to take place. The amendments take varying forms. The most common type of amendment introduced during this period is the "fair price" provision, which consists of a supermajority requirement to approve a merger or sale of assets unless the offer is approved by the board of directors or the bidder pays a "fair price" for all shares. This "fair price" frequently is defined to equal the highest price paid by the bidder in acquiring his position in the firm up to the time of the bid. Other types of amendments require a supermajority to approve a merger or sale of assets (with no fair price clause), establish a classified board of directors (increasing the length of time needed to replace the entire board) or allow the firm to issue preferred stock (with the effect of diluting the voting power of an unfriendly bidder).

Corporate managers argue that these antitakeover amendments are necessary for several reasons. They suggest that the protection provided by the amendments allow them to concentrate on running the firm rather than worrying about corporate raiders. In addition, it is argued that antitakeover measures may force bidders to pay a higher price for target shares to increase the probability of any bid being successful. However, if antitakeover measures are successful in discouraging mergers or tender offers which would have otherwise occurred, shareholders will not have the opportunity to receive the substantial premiums paid, on average, in these transactions. Thus, according to some, these amendments simply serve to entrench incumbent management at shareholder expense.

We investigate share price reaction (adjusted for market returns) around the proxy signing date of firms which introduced antitakeover amendments during the last six years. As shown in Table 1, 474 antitakeover amendments were introduced during this period. Most of these amendments (372) were for fair price provisions, with the remaining split between supermajority requirements (76) and classified boards or authority to issue blank-check preferred stock (26).

We find that the different amendment types vary in their impact on shareholder wealth. Overall, from 20 trading days before through 10 trading days after the proxy signing date, shareholders of the 404 firms included in our empirical work lost an average 1.27% of the value of their shareholdings, after adjusting for market returns. (See Table 2.) Most of this loss results from firms which introduced non-fair price provisions -- that is, those firms that adopted supermajority requirements, classified boards or authority to issue blank-check preferred stock. Shareholders of these 85 firms lost an average 4.06% in the value of their holdings, significantly different from zero. We find no evidence of any significant share price effect in any of the trading intervals reported around the proxy signing date for firms announcing fair price amendments.

Thus, the evidence suggests that fair price provisions, which essentially protect shareholders against two-tier tender offers that have a lower "back-end" price, have little impact on shareholder wealth. Supermajority requirements do have a negative impact but these amendments have greatly decreased in popularity relative to fair price provisions over the six years of our sample. This trend suggests that shareholders have recognized the impact of supermajority provisions on their wealth and have encouraged management to introduce amendments such as fair price provisions which are, on average, less harmful.

Table 1

Number of Antitakeover Amendments in Survey
by Type of Amendment, for each year 1979-1984

	Absolute Number				Number of Fair Price	
Year	Fair Price	Super-Majority	Other	Total	Relative to Yearly Totals	Relative to All (372) Fair Price
1979	12	1	0	13	.92	.03
1980	10	23	1	34	.29	.03
1981	5	17	0	22	.23	.01
1982	11	13	2	26	.42	.03
1983	161	22	23	206	.78	.43
1984	173	-	-	173	N.A.	.47
ALL	372	76	26	474	N.A.	1.00

Source: Drexel, Burnham and Lambert, Shareholder Protective Amendment Analysis, 1984.

Kidder, Peabody, Effects of Adoption of Fair Price Amendments on Stock Prices and Institutional Ownership, 1984.

Table 2: Net - of - Market Stock Returns Around Proxy Signing Date For Firms Passing Antitakover Amendments, By Type, for Various Intervals, 1979-84.

A. All Anti-Takeover Amendments (404)

Interval	MEAN	t(MEAN)	Percent of CER's Neg.	t(%)
CER (-20,10)	-1.27	-1.93	.55	2.00
CER (-20,5)	-0.85	-1.38	.52	0.80
CER (-10,10)	-0.47	-0.91	.53	1.20
CER (-10,5)	-0.05	-0.10	.52	0.80

B. Non - Fair Price (85)

Interval	MEAN	t(MEAN)	Percent of CER's Neg.	t(%)
CER (-20,10)	-4.06	-2.55	.60	1.89
CER (-20,5)	-3.66	-2.44	.64	2.69
CER (-10,10)	-2.26	-1.79	.62	2.26
CER (-10,5)	-1.87	-1.62	.66	3.08

C. All Fair Price (319)

Interval	MEAN	t(MEAN)	Percent of CER's Neg.	t(%)
CER (-20,10)	-0.53	-0.74	.53	1.07
CER (-20,5)	-0.10	-0.15	.50	0.00
CER (-10,10)	0.01	0.10	.51	0.36
CER (-10,5)	0.44	0.89	.48	-0.71

EXHIBIT D

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE CHIEF ECONOMIST

OFFICE OF
THE CHIEF
ECONOMIST

May 17, 1985

RE : Adoption of Poison Pills and Impact on Shareholder Wealth

Over the last two years, 15 firms have adopted "poison pills" as takeover defenses. In a poison pill defense, holders of the company's common stock are issued rights to purchase a newly issued class of preferred stock or other security. However, these rights may be exercised only when a triggering event occurs. Triggering events may include a tender offer for the firm's shares or the acquisition by an outside party of a large block of the company's stock.

Rights issued in the poison pill defense take many forms. They may allow the target firm's shareholders to purchase common stock of the acquiring firm at a substantial discount (as in the Household International case) or they may allow the target firm's shareholders to swap their shares of common stock for other securities, such as the one-year notes valued significantly above the existing share price in the Phillips Petroleum defense. Poison pills are effective as a takeover defense because the target company becomes prohibitively expensive to any potential acquirer not approved by the board of directors.

OCE has studied the impact on shareholder wealth of the adoption of these poison pills. Because poison pills are often adopted in the midst of takeover rumors and contests, it is difficult to sort out the impact of the adoption of a poison pill as separate from other events affecting the stock price. However, by concentrating on share price changes (adjusted for changes in the overall market) during a very small window around the announcement day of a proposed poison pill, we have tried to isolate the poison pill effect.

Table 1 presents results from our study of share prices of 15 firms which announced poison pills from June 1983 (Lenox International) through April 1985 (Unocal). (Table 2 lists the firms in our sample.) We find that, on average, firms suffered a 1.98% share price loss on the day before and the day the poison pill is announced in the Wall Street Journal. This loss is significantly different from zero at the 95% probability level. On the day of the Wall Street Journal announcement, firms lose an average of 1.03%, significantly different from zero at the 85% probability level. On the announcement day, 73.3% of the returns were negative.

Over the longer event periods (days (-10, +5) and days (-10, +10)), returns remain negative but are no longer significantly different from zero. This result is not surprising due to the increased noise in the returns over the longer time period.

The evidence indicates that poison pills cause a small but significant wealth loss to shareholders of adopting firms. This loss probably results from the lowered probability of a successful tender offer and the loss of the substantial premiums paid for shares in these offers. However, managers of adopting firms argue that there is a real benefit to shareholders from these provisions. If the poison pill forces a potential acquiror to pay a higher premium for the firm, then shareholders do gain. The risk is that the poison pill will prevent a takeover bid from being made.

Table 1
Net-of-Market Stock Returns Around the
Wall Street Journal Announcement Date
For 15 Firms Proposing Poison Pill Defenses

Trading Day Interval Around Announcement Date	Mean Net-of-Market Return (%)	T-Statistic
Day (0)	-1.03	-1.71*
Day (-1) to Day (0)	-1.98	-2.25**
Day (-10) to Day (+5)	-1.18	-0.49
Day (-10) to Day (+10)	-1.48	-0.53

NOTES:

* Significantly different from zero at the 85% probability level.

** Significantly different from zero at the 95% probability level.

Table 2
Company Names and Announcement Dates of
Firms Proposing Poison Pill Defenses

Company	Date
Lenox Inc.	6-16-83
Bell & Howell Co.	7-18-83
Enstar Corp.	8-16-83
Superior Oil Co.	11-25-83
Warner Communication Inc.	1-13-84
Crown Zellerbach Corp.	7-20-84
Owens-Illinois Inc.	9-12-84
Household International Corp.	9-13-84
Colgate Palmolive Co.	10-15-84
Southwest Forest Industries, Inc.	10-23-84
Johnson Controls Inc.	11-21-84
Rorer Group Inc.	2-8-85
Phillips Petroleum	2-11-85
Morton-Thiokol Inc.	3-29-85
Unocal Corp.	4-17-85

NO-WIN POSITION

Senator D'AMATO. I think Chairman Shad is in a no-win position here because I hear both sides, Senator, and I'm kind of saying it. It just seems to this Senator, after having heard not only yesterday's panel and today's, but having had so many visits and so many meetings with people who are concerned about this area, that both sides have legitimate concerns. Those corporations who want to resist the takeovers that they feel are legitimately not in the interest of their companies or their shareholders—and the raiders who feel that they can do a better job and see an opportunity for their own economic advancement as well as that of the corporation that they seek to acquire.

Two points stand out—and I'm wondering if you would comment on it—two objectionable points seem to be greenmail, on one side, and then the disenfranchisement of shareholders on the other side.

Now, if a consensus can be made along there, why wouldn't it be appropriate then for the Congress to undertake legislative initiatives to deal with that and wouldn't that be an evenhanded way of not tilting Williams for or against those who seek to take over and those who seek to defend.

Mr. SHAD. I'd like to give it very careful consideration, but I appreciate the balance that you're suggesting. Removing the greenmail proposal I have a difficult problem with because I'm still where the Commission was, when we proposed, proscribing greenmail. I think that that had real merit.

But I am also sensitive to the response that's going on in the marketplace and the new laws which tend to inhibit it and the fact that companies are responding to it through their charter and bylaws.

Senator D'AMATO. Look at the way they've responded to it, in certain cases. It's one thing to say that you are not going to engage and they have to have all the shareholders participate or the offer has got to be made to all of the shareholders, not just a select few. That, I think, is an adequate response.

But what about the overreaction of those who've engaged in some of the activities which just disenfranchise their shareholders.

Could you do an analysis as to—with the number of corporations you've outlined that have taken defensive postures, how many have gotten into this area of the poison pill reaction as opposed to those that have simply said we're not going to pay blackmail—or you want to say greenmail, and I think it's blackmail—and we're simply not going to engage in that, and we write it in so don't waste your time coming after us if you're not going to really come after us all the way.

I'm wondering if we could have some numbers at some time.

Mr. SHAD. I could provide some preliminary numbers. I believe it's 5 or 6 that have actually adopted but about 20 have proposals out right now to adopt antigreenmail provisions, charter amendments——

Senator D'AMATO. You're saying 5 or 6 have adopted, about 20 have indicated an attention, but there have been 4 to 500 others who've gone the other way.

Mr. SHAD. Well, that's on a different issue. But on the greenmail, there are about, I believe, 20 that are now proposing to proscribe, and or limit in some way, greenmail transactions; these are early—you know, I see a trend.

I see the marketplace or the corporations reacting in that fashion. I also see the limitations imposed—effectively imposed in my mind—in the Deficit Reduction Act where you can't borrow to buy the stock or get the full 85-percent dividend exclusion if you borrow money to buy stock.

I don't think it was specifically addressed to greenmail, but I think that that limitation and these kind of things that are going on are having an effect.

Senator D'AMATO. Chairman Shad, I want to thank you for your participation. I don't know if Senator Proxmire has any other questions of the Chairman before we ask our next witnesses.

Senator PROXMIRE. I just have one or two very brief questions and I apologize—I realize we have Chairman Martin and Director Wright waiting.

I would like to ask you, you said the justification for greenmail, a little earlier, was because they permitted mergers to go ahead. Can you cite one merger that went ahead because of greenmail and served the national interest?

Mr. SHAD. I'm sure that we can come up with them, yes, but offhand—you're talking about people's motivations and my point was that the way station of greenmail is one of the factors that enters into the hostile groups' decision to accumulate—to assume the front-end expense and cost and capital commitments, reasoning that there's the possibility of a greenmail transaction at substantial profit. And, if not, of putting the company into play and bringing in other bidders and/or going full term yourself for the company.

So it's—I think—a factor in the risk-reward ratio that the people engaged in these transactions carefully assess and——

Senator PROXMIRE. I understand your view on that, Mr. Shad. Would you, for the record, just provide a few instances of that?

[The following information was subsequently submitted for the record:]

Response to Questions of Senator Proxmire
Hearing of April 4, 1985

Question. Can you cite one merger that went ahead because of greenmail and served the national interest?

Answer.

Because the Commission's mandate does not extend to examination of the merits of transactions, we are unable to speak to whether any particular merger served the national interest. Following, however, is a description of several transactions in which a greenmail payment was followed by merger.

Blue Bell, Inc., purchased approximately 23% of its outstanding common stock from the Bass Brothers in November 1983 at an average price of $48.39 per share when the market price was approximately $36.75 per share. Blue Bell announced in May 1984 that it was engaged in discussions concerning a leveraged buyout proposal by management of the Company at $50 per share. A merger agreement designed to effect a management LBO at a price of $47.65 per share was executed in August 1984.

St. Regis Corporation purchased approximately 8.6% of its outstanding common stock from Sir James Goldsmith in March 1984 at a price of $52 per share when the market price was approximately $39.90 per share. Champion International Corporation commenced and completed a friendly two-tier tender offer and merger with St. Regis Corporation in August 1984. The consideration received by St. Regis Shareholders was $55.50 per share in the first step and 2.85 shares of Champion International common stock in the second step.

Avco Corporation purchased approximately 10% of its outstanding common stock from Leucadia National Corporation in August 1984 at a price of $35.75 per share ($.25 below the previous days closing market price) and agreed to pay Leucadia the difference between $35.75 per share and the price per share paid pursuant to any tender offer or merger recommended by the Company within one year multiplied by 2,796,400. Avco Acquisition Corporation, a wholly owned subsidiary of Textron, Inc., and Avco Corporation executed a definitive merger agreement in December 1984, pursuant to which Avco Acquisition commenced a tender offer for all outstanding shares at a price of $50 per share.

OFFICE OF THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 31, 1985

TO : Peter Kiernan, Legislative Counsel
Office of Legislative Affairs

FROM : Joseph G. Connolly Jr., Chief
Office of Tender Offers
Division of Corporation Finance

RE : Congressional Hearing Related Request

SUBJECT: Number of Issuers that have (a) adopted "poison pill" security plans and (b) proposed for adoption "anti-greenmail" charter provisions.

At the April 4, 1985, Senate Subcommittee on Securities hearings on Tender Offers, the Chairman was requested to provide the Subcommittee with the number of issuers that have adopted "poison pill" security plans and the number of issuers that have proposed for adoption "anti-greenmail" charter provisions. Set forth below is the information requested for fiscal year 1985.

"Poison Pill" Security Plans

AMF
Amsted
ASARCO
Burroughs Corp.
Colgate Palmolive Co.
Electronic Systems Tech
Excel Industries
General Host Corp.
Great Lakes International
Jerrico Inc.
Johnson Controls
Michigan National Corp.
Morton-Thiokol
Phillips Petroleum
Rorer Group
Southwest Forest Industries
Unocal
Wainoco Oil

Anti-Greenmail Provisions

Aluminum Co. of America
American President Co.
Anheuser Busch Co.
Apache Corp.
Argo Petroleum Corp.
Atlantic Richfield
Avery International
Bausch and Lomb Inc.
Chesebrough Ponds
Cole Laboratories
Cordura Corp.
Cross and Trecker Corp.
Diamond Shamrock
Dover Corp.
Dresser Industries
Eastern Gas and Fuel
Endevco Inc.
Fay's Drug
Fleming Companies
Franklin Bancorp.
Fugua Industries
B.F. Goodrich
Gould Inc.
Heck's Inc.
Informatics General
Interco Inc.
KDI Corp.
Kaneb Services Inc.
Kerr-McGee Corp.
Lubrizol Corp.
Lufkin Corp.
Martin Marietta
Mobil Corp.
NCR Corp.
NWA Inc.
Owens and Minor Inc.
Pacific Gamble Robinson
Shoney's South Inc.
Singer Company
Sterling Drug
Thomas and Betts Corp.
WARNACO

JUNK BOND FINANCING

Finally, there's been a great deal of criticism regarding so-called junk bond financing of takeovers. By junk bond, I mean the lowest rated bond that goes with the investment.

It's my understanding that the risks of investing in these issues are rising and the losses to investors and bankruptcies in 1984 were more than double the combined losses from 1976–83.

Would you please explain the junk bond financing market to us including the size of the market for junk bond financing takeovers?

Mr. SHAD. Well, it's grown expotentially over the last 10 years, certainly, and the largest market for so-called junk bonds or high-yield, low-grade bonds, are institutions. They're very sophisticated buyers, and it's basically on an analysis that demonstrates that markets change over time.

But that demonstrates that the yield difference—the greater yield that you get on junk bonds has more than covered the default experience over an extended—throughout the Great Depression, the 1929 period, all the way up to the present.

The yield differential has more than covered the default experience, and in addition, AAA bonds only have one way to go in terms of rating, and that's down; they can't get any higher. So-called junk bonds are BB or lower rated. In other words, investment grade is a BBB. And bonds that are rated BB and B often do get upgraded over time. So that there's a prospect not only of a yield differential, but an enhancement in the quality of the bond.

Now, it is true that they are risky; they're very risky, and in a serious recession or a period of rapidly rising interest rates, the companies that are obligated under the junk bonds could get into financial difficulties. But that's true of all highly leveraged-type situations.

Senator PROXMIRE. What likelihood is there that other investment banks in addition to Drexel-Burnham will gear up possible junk bond takeover efforts?

Mr. SHAD. Well, I've been very impressed with what they've achieved, I would say, in terms of their position in that market. And, again, they've sold these issues to institutions, I think, overwhelmingly so.

But First Boston has recently risen to the top of the list, which is quite surprising. They're a much more traditional investment banking firm.

Senator PROXMIRE. Do you have any analysis of who the buyers of junk bonds and takeovers are or what their relationships are, if any, to sellers and other buyers?

Mr. SHAD. Yes, sir; in the early stages it was the income funds. It was professional, mutual fund-type entities that bought them for individuals and corporations that wanted the above-average yield under professional management, under the management of the investment company.

Today, it's much more broadly spread but, again, among institutional investors, primarily, pension funds, and savings and loan associations and other forms of investment companies.

Senator PROXMIRE. Thank you, Mr. Shad.

Senator D'AMATO. Senator Cranston.

TAX CODE ENCOURAGES TAKEOVERS

Senator CRANSTON. Mr. Shad, it's been said that the Tax Code is not neutral with respect to hostile takeovers and leverage buyouts and breakup liquidations, but that the code actually encourages them. Fred Hartley, the chairman of Unocal, stated, "Taxpayers of the United States should not be forced to pay part of the cost for a raiders course of action." And said, we should consider an end to deductions of interest costs on money borrowed for this activity.

What, if anything, do you feel Congress should do about that?

Mr. SHAD. I feel that if you draw the conclusion that the tender offer activities are antisocial, undesirable in one way or another, that is one way to address it. But I would first question whether or not it is that negative. These are both pluses and minuses on that issue, and I question whether you'd single out this type of transaction against all others in the use of borrowed funds. There are more friendly mergers than there are hostile takeovers. And you're going to permit the majority of them to use borrowed funds and get the full tax benefits of interest deductions but carve out this one segment——

It seems to me that the Tax Code and tax policy should be used for fiscal policy rather than to regulate social policy. I also support what the Treasury's trying to do now in terms of simplification of the thing, to get it to its primary purpose with a minimum across-the-board-type of taxation, rather than use it for all these different social purposes that have grown up over the years. So that there all kinds of things which people would call loopholes to facilitate this social policy or penalties on another side.

I don't support that approach.

Senator CRANSTON. In 1980, the SEC recommended that Congress enact a provision dealing with private rights of action for violations of the Williams Act, and Senator Heinz and Chafee, among others in the Senate, supported that recommendation.

I'd like to read you the SEC's rationale at that time. It's a slightly lengthy statement which is as follows:

> With limited resources the Commission itself cannot be expected to bring actions in all instances where the Williams Act appears to have been violated. The parties to the takeover bid are programmed for acquisition of control whether the bidder, the subject company, or its shareholders, are often in a better position to enforce compliance with the law. Moreover, such actions often serve as the only practical means of compensating persons who have suffered real financial injury as a result of a violation. It is through a combination of public and private enforcement effort, then, that public and investor interests are best protected. In any case, expressed creation of a cause of action will provide the best foundation to ensure that such rights will continue to be available to persons aggrieved by violations of the law and to resolve expressly questions relating to such issues as standing, defenses, damage limits and statutes of limitation.

That was the SEC's position in 1980. What is the position today? Has there been any change?

Mr. SHAD. Well, the Commission hasn't readdressed that issue since I've been there in the past 4 years. There's been a total turnover of the entire Commission. So I can't express the position of the present Commissioners on that issue.

I'll be glad to add, however, that I think that much of what has been raised is in the present law today. In other words, shareholders do have a private right of action in a wide variety of the situa-

tions that arise, in terms of whether it's full disclosure, and so forth, and no false or misleading or illegal-types of trade practices—and my general counsel is tugging at me.

Mr. GOELZER. We have consistently filed amicus briefs supporting private actions under the Williams Act for precisely the reasons that you've read. I think we've filed those as recently as the last couple of months.I21Senator CRANSTON. So, basically, that's still the position?

Mr. GOELZER. Yes, sir; I'm speaking of a litigation position rather than a legislative position, that is our position, yes.

Senator CRANSTON. Thank you very much.

Senator D'AMATO. Chairman Shad, Senator Heinz and I have a number of questions that I'd like to submit to you and hope that you would answer them for the record. We'll submit them in writing to you so that we can proceed with this hearing and I thank you for being here once again and being as candid as you've been.

I'm going to press you on the issue, again, of the balance with respect to greenmail and the poison pill tactics being undertaken and I'll ask you once again to review as to whether or not the SEC should not contemplate bringing an action under section 19(c) against the various exchanges to get them together. Perhaps they will undertake something voluntarily, lest we do it by way of legislative initiative.

Mr. SHAD. Thank you very much, Senator D'Amato.

Senator D'AMATO. Thank you.

[The complete prepared statement of Mr. Shad and response to written questions of Senators D'Amato and Heinz follow:]

STATEMENT OF JOHN S.R. SHAD
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES

Thursday, April 4, 1985

Chairman D'Amato and Members of the Subcommittee:

The Commission appreciates this opportunity to testify on the evolution of the tender offer process and on the agency's experience and practices in administering the Williams Act. The Commission looks forward to working with the Subcommittee as it continues its comprehensive review of tender offers.

I. ENACTMENT OF THE WILLIAMS ACT IN RESPONSE TO EMERGENCE OF THE TENDER OFFER AS AN ACQUISITION TECHNIQUE

The development of the tender offer as a frequently used method to acquire control of a corporation is a relatively recent phenomenon, dating from the 1960s. Prior to 1960, tender offers were few in number. In 1960, for example, there were only seven tender offers for corporations with securities listed on national exchanges. 1/ By the mid-1960s, however, the annual number of tender offers for such companies had increased to more than 100. 2/ Since 1980 there has been over a five fold increase in the dollar amount of tender offers to over $45 billion in 1984. 3/

1/ Attached as Exhibit A is a chart showing the number of tender offers, and the related dollar amounts, from 1956 to 1984.

2/ Exhibit A. See also S. Rep. No. 550, 90th Cong., 1st Sess. 2 (1967) ("Senate Report"); H. Rep. No. 1711, 90th Cong., 2nd Sess. 2 (1968) ("House Report").

3/ Exhibit A.

Prior to the mid-1960's, businesses were typically combined by merger, sale of assets, or consolidation, or through proxy contests. Exchange offers and mergers in which the consideration offered was a security were subject to the Securities Act of 1933. Proxy contests were subject to the proxy provisions of the federal securities laws, as well as to state law.

With the increased use of hostile tender offers, companies became increasingly concerned about the secrecy and speed with which they were conducted. Federal law did not require the bidder to disclose his source of funds, his plans upon acquiring control, or his identity. 4/

In adding the Williams Act provisions to the Securities Exchange Act in 1968, 5/ Congress sought to ensure that shareholders would have adequate time and information to accept or reject a tender offer. Congress indicated that tender offers served "a useful purpose in providing a check on entrenched but inefficient management." 6/

Congress stated that it intended to avoid "tipping the balance of regulation either in favor of management or in favor of the

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4/ House Report at 2-3; Senate Report at 2.

5/ The Williams Act added new Sections 13(d), 13(e), 14(d), 14(e) and 14(f) to the Securities Exchange Act. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454 (codified at 15 U.S.C. 78m(d)-(e) and 78n(d)-(f)).

6/ Senate Report at 3.

person making the takeover bid" 7/ and that the statute was designed to protect investors by ensuring that "the offeror and management [each have] equal opportunity to fairly present [their] case." 8/ Attached as Exhibit B is a study reflecting the returns to both target company shareholders and bidders, both prior to and subsequent to the enactment of the Williams Act.

Congress required that tender offerors provide specified types of information, intended to aid security holders in deciding whether to sell. Congress rejected a requirement that such information be publicly filed or otherwise made available to target company management prior to the commencement of the tender offer. It felt that such a requirement was unnecessary for the protection of shareholders 9/ and would have made it possible for the target company's management to take steps to delay or defeat a tender offer before the target's security holders learned of it. 10/

7/ House Report at 4.

8/ Id.

9/ See, e.g., Full Disclosure of Corporate Equity Ownership and In Corporate Takeover Bids: Hearings on S. 510 Before the Subcommittee on Securities of the Senate Committee on Banking and Currency, 90th Cong., 1st Sess. 71-76, 84-85, 87-89, 98, 105, 108-11, 139-40, 151, 163 (1967) ("Senate Hearings").

10/ As the Supreme Court has observed, by "requiring disclosure of information to the target corporation as well as the Securities and Exchange Commission, Congress intended to do no more than give incumbent management an opportunity to express and explain its position." Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58 (1975).

II. REGULATION OF TAKEOVER BIDS UNDER THE WILLIAMS ACT

A. Overview of Major Williams Act Provisions

The Williams Act requires disclosure of certain acquisitions of securities, regardless of the method of acquisition. Any person who acquires beneficial ownership of more than 5% of the equity securities of certain public companies must file a statement within 10 days after the acquisition of such interest. The statement must describe, among other things, the purchaser's background, the purposes of the acquisition, and any plans or proposals for acquiring control of, merging with, or liquidating the issuer. This statement is required to be sent to the issuer, to the exchanges on which the security is traded, and to the Commission. 11/

The Act also regulates the conduct of tender offers for the equity securities of certain publicly traded companies. At the time the tender offer is commenced, material information must be disclosed to the Commission, the target company, and its security holders. 12/ The statute also provides the foundation for substantive provisions governing tender offers, described in Part IIB below.

In addition, the Act prohibits misrepresentations, omissions, misleading statements of material fact and fraudulent, deceptive, or manipulative acts or practices in connection with any tender

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11/ Section 13(d) of the Securities Exchange Act, 15 U.S.C. 78m(d).

12/ Section 14(d) of the Securities Exchange Act, 15 U.S.C. 78n(d).

offer. 13/ A 1970 amendment to this antifraud provision gives the Commission the power to "define, and prescribe means reasonably designed to prevent" practices that are "fraudulent, deceptive, or manipulative * * *." 14/ Congress sought to give the Commission "full rulemaking powers" to protect investors in connection with any tender offer. 15/

B. Mechanics of the Tender Offer Process

In 1979 the Commission adopted Regulations 14D 16/ and 14E 17/ to govern third-party tender offers. 18/ Regulation 14D establishes filing, delivery and disclosure requirements, optional dissemination provisions and certain substantive protections to tendering shareholders with respect to tender offers for "Section 14(d)(1)

13/ Section 14(e) of the Securities Exchange Act, 15 U.S.C. 78n(e).

14/ See Hearings Before the Subcommittee on Securities of the Senate Committee on Banking and Currency on S. 336 and S. 3431, 91st Cong., 2d Sess. 1 (March 25, 1970) (statement of Senator Williams) ("1970 Senate Hearings").

15/ See 1970 Senate Hearings at 2 (statement of Senator Williams).

In addition to the amendment of Section 14(e), Congress amended the Williams Act in two other significant ways in 1970: (i) the reporting thresholds in Sections 13(d) and 14(d) were reduced from 10% to 5% beneficial ownership; and (ii) coverage was broadened to include exchange offers as well as cash offers.

16/ SEC Rules 14d-1 through 14d-9, inclusive, 17 C.F.R. 240.14d-1 through 240.14d-9.

17/ SEC Rules 14e-1 through 14e-3, inclusive, 17 C.F.R. 240.14e-1 through 14e-3.

18/ Issuer tender offers are governed by Section 13(e) and the rules promulgated thereunder.

securities." 19/ Regulation 14E defines certain unlawful tender offer practices, requires a statement of the target company's position with respect to the tender offer, and establishes a disclose or abstain from trading rule for persons in possession of material non-public information with respect to any tender offer.

A tender offer is deemed to commence when its material terms are first disclosed to the public or when the offer is first published or sent or given by the bidder to security holders. 20/ The Commission's rules prohibit a bidder from making a tender offer subject to Section 14(d) unless, "as soon as practicable on the date of commencement of the offer," the bidder:

19/ Section 14(d)(1) of the Exchange Act regulates all tender offers for, or a request or invitation for tenders of, any class of equity security (i) registered under Section 12 of the Exchange Act or (ii) issued by registered closed-end investment companies or certain regulated insurance companies, provided, upon consummation of the offer, the offeror will own beneficially more than 5% of the outstanding shares of that class. Equity securities are required to be registered under Section 12 if (a) they are to be listed on a national securities exchange or (b) the class of such equity security is held of record by 500 or more persons and the issuer has assets of $3,000,000 or more.

20/ SEC Rule 14d-2(a), 17 C.F.R. 240.14d-2(a). If a bidder fails to comply with the filing and dissemination requirements within 5 business days after it publicly announces the offer's material terms, and does not publicly withdraw the offer, the offer is deemed to have commenced upon the public announcement. Rule 14d-2(b), 17 C.F.R. 240.14d-2(b). The bidder's failure to comply would constitute a violation of Rule 14d-3, which requires dissemination of the Schedule 14D-1 as soon as practicable on the date of commencement. The material terms of a tender offer consist of the identities of the bidder and target companies, the amount and class of shares being sought, and the price or range of prices being offered. Rule 14d-2(c), 17 C.F.R. 240.14(d)-2(c).

A. files with the Commission a Tender Offer Statement on Schedule 14D-1, and hand delivers a copy both to the subject company and to any other bidder which has filed a Schedule 14D-1 covering a pending offer for the same class of shares;

B. gives telephonic notice of certain specified material terms of the offer, and mails a copy of its Schedule 14D-1 to each national securities exchange on which the subject shares are listed; and

C. adequately disseminates the tender offer to shareholders. 21/

Schedule 14D-1 calls for three basic categories of disclosure items: (i) information relating to the subject company and its securities; (ii) information concerning the identity and background of the persons filing 22/; and (iii) information concerning the terms of the bid. 23/ The bidder also must disseminate a fair

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21/ SEC Rule 14d-3(a), 17 C.F.R. 240.14d-3(a); SEC Rule 14d-6, 17 C.F.R. 240.14d-6.

22/ If the bidder is not a natural person and its financial condition is material to the investment decision being presented, appropriate financial information must be included relating to the bidder.

23/ Among the specific disclosures required are information concerning the source and amount of funds used or to be used for the acquisition, and contractual and other arrangements and understandings relating to the securities being acquired. The Schedule 14D-1 must also disclose the exact number of shares being sought; the consideration being offered; the identity of the principal market in which the securties are traded; and any transactions and negotiations between the bidder and the subject company for the preceding three fiscal years. The Schedule must also disclose the purpose of the tender offer and the plans of the bidder relating to changes in management, transfer of assets, and extraordinary corporate action such as a merger or liquidation.

and adequate summary of the information included in its Schedule 14D-1, as well as certain additional information, to shareholders of the target company. 24/

The Commission's tender offer regulations also require the target company to file and disseminate a disclosure statement setting forth its position with respect to a tender offer within 10 business days of its commencement. 25/ Certain other interested persons who make solicitation or recommendation statements also must file disclosure statements. 26/

The bidder cannot purchase shares of the target except pursuant to the terms of the tender offer. 27/ The offer must remain open for at least 20 business days from its commencement, and must be extended for 10 business days if the bidder increases the offering price. 28/ Shareholders have the right to withdraw any shares tendered in response to an offer at any time until the expiration of 15 business days from its commencement. 29/ If shares have not

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24/ SEC Rule 14d-6, 17 C.F.R. 240.14d-6.

25/ SEC Rules 14d-9, 14e-2, 17 C.F.R. 240.14d-9, .14e-2.

26/ SEC Rule 14d-9, 17 C.F.R. 240.14d-9.

27/ SEC Rule 10b-13, 17 C.F.R. 240.10b-13.

28/ SEC Rule 14e-1, 17 C.F.R. 240.14e-1.

29/ SEC Rule 14d-7(a)(1), 17 C.F.R. 240.14d-7(a)(1).

yet been purchased, shareholders have the right to withdraw tendered shares for 10 business days following the commencement of a competing bid (other than a bid made by the target company) 30/ and at any time more than 60 days from the date the offer commenced. 31/

The best price rule of the Williams Act requires that the highest consideration offered to any shareholder during a tender offer must be paid to all shareholders from whom shares are purchased pursuant to the offer. 32/ In order to afford security holders adequate time to consider the merits of a tender offer, 33/ the Commission adopted a rule requiring that a bidder in an over-subscribed partial tender offer accept securities on a pro rata basis according to the number of securities deposited by each depositor prior to the expiration of the offer. 34/

Pursuant to its authority to define and prescribe means to prevent fraudulent practices, the Commission established a "disclose or abstain from trading" rule under the Williams Act. That rule prohibits communicating or trading, while in possession

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30/ SEC Rule 14d-7(a)(2), 17 C.F.R. 240.14d-7(a)(2).

31/ Securities Exchange Act Section 14(d)(5), 15 U.S.C. 78n(d)(5).

32/ Securities Exchange Act Section 14(d)(7), 15 U.S.C. 78n(d)(7).

33/ SEC Release No. 34-19336, 47 Fed. Reg. 57679 (December 28, 1982).

34/ SEC Rule 14d-8, 17 C.F.R. 240.14d-8.

of certain material nonpublic information, "[i]f any person has taken a substantial step or steps to commence * * * a tender offer * * *." 35/ The rule also contains certain exceptions pertaining to multi-service financial institutions and brokerage transactions.

C. Commission Tender Offer Review Program

The Commission has sought to administer the Williams Act in a manner that neither facilitates nor obstructs tender offers. The Commission is sensitive to Congress' intent that both the bidder and the target have relatively equal opportunities to state their cases to the decision makers, the shareholders of the target company.

The Commission's review of tender offer materials is conducted by the Division of Corporation Finance through the staff comment process. The comment process, designed to ensure investor protection, is impartial and avoids tipping the balance in a contest for control.

The staff reviews tender offer materials whether the tender offer could be characterized as "friendly" or "hostile." During fiscal year 1983, the staff reviewed each of the 92 filings by bidders and all recommendation statements filed by management and others. For fiscal year 1984, the staff reviewed each of the 121 filings

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35/ SEC Rule 14e-3, 17 C.F.R. 240.14e-3.

by bidders and all recommendation statements filed by management and others. 36/

III. DEVELOPMENTS IN TENDER OFFER PRACTICES; FORMATION OF TENDER OFFER ADVISORY COMMITTEE

A. Post-Williams Act Changes in Tender Offer Practices

There have been significant developments in the manner in which takeovers occur since the adoption of the Williams Act. 37/ Most dramatic of the more recent changes is the appearance of the "billion dollar takeover bid." Since the $7.8 billion takeover of Conoco Inc., by DuPont in 1981, successful large cash bids have been made for Gulf Corporation ($13.3 billion), Getty Oil ($10.1 billion), Shell Oil Company ($5.5 billion), Marathon Oil Company ($3.75 billion), Carnation Company ($2.9 billion), Cities Service Company ($1.92 billion), and Texas Gas Resources ($1.637 billion).

Additionally, a variety of complex bidding strategies have emerged. Among these bidding strategies are "two-tier" bids, 38/

36/ Attached as Exhibit C is a list of Commission enforcement actions commenced on or after July 1, 1981 relating to changes in corporate control. Attached as Exhibit D is a list of amicus briefs filed on or after July 1, 1981.

37/ See Advisory Committee on Tender Offers -- Report of Recommendations, at xvi (July 8, 1983) (the "Advisory Committee Report").

38/ "Two-tier pricing" or a "two-tier bid" refers to an acquisition, initiated by a tender offer, where the per share consideration is higher for one portion of the shares to be acquired than for the other portion.

the uses of multiple prorationing pools, 39/ and "front-ended loaded" bidding. 40/

Changes in bidding strategies and the apparent vulnerability to takeover bids of even large issuers have evoked a variety of defensive strategies. Among these have been the "Pac Man" defense where the target makes a counter tender offer for the bidder's stock, defensive issuer reacquisition of its shares where the target makes a competing bid for its own stock, and the "poison pill," where the target issues a security in the form of a dividend that provides for conversion into the bidder's stock at a prescribed rate if the bidder succeeds in gaining control of the target.

Defensive strategies also include the increasing use of anti-takeover provisions. Many issuers have adopted supermajority voting requirements, which raise to high levels the percentage of shareholder votes required to approve major transactions, such as

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39/ Prior to the amendment of SEC Rule 14d-8 in 1982, the minimum period during which securities had to be purchased on a pro-rata basis in the event a partial tender offer was oversubscribed -- the "proration period" -- was ten calendar days. Any increase in the consideration thereafter would result in the creation of a second ten day proration pool, notwithstanding the fact that the bidder had already received in the first proration pool more shares that it was willing to take up. In December 1982, the Commission adopted SEC Rule 14d-8, 17 C.F.R. 240.14d-8, which, as discussed supra, required that proration rights be extended throughout the offering period. This eliminated the use of multiple prorationing pools.

40/ "Front-end loaded" bidding involves a tender offer for a minimum control amount at a high premium, followed by an acquisition of the remaining outstanding shares at a significantly lower price usually by way of a second-step merger.

mergers and board member elections; two classes of common stock, with one class often having significantly greater voting power than the other; "fair price" provisions governing the price required to be paid in a two-step merger; and/or limitations on the total voting power which can be exercised by a single person.

Two other byproducts of increased takeover activity are issuer share repurchases at a premium to market, known as "greenmail," and compensation provisions that trigger upon a change of control or other events related to a change of control, known as "golden parachute" arrangements.

Recent examples of "greenmail" have included the Bass Brothers' sale of their Texaco shares to Texaco for $1.28 billion, a premium of 12%, and Reliance Holdings' sale of their Disney shares to Disney for $325.3 million, a premium of 30.6%. Recent events involving Phillips Petroleum Company, including Phillips' proposed recapitalization plan, also reflect changing developments in tender offer practices.

B. Formation, Objectives, and General Conclusions of the Tender Offer Advisory Committee

In light of these developments, the Commission decided to reexamine the tender offer process. To initiate a comprehensive review, Chairman Shad established the Advisory Committee on Tender Offers on February 25, 1983.

The Advisory Committee included 14 prominent members of the financial, legal, and accounting professions who have been actively involved in numerous tender offers in behalf of both bidders and targets. The Committee also included two academicians who have written extensively on the subject of tender offers, a former Supreme Court Justice, and a former state securities commissioner.

The Advisory Committee's mandate from the Commission was to review tender offer practices and regulations and propose specific regulatory and legislative improvements for the benefit of all shareholders (i.e., shareholders of all corporations, whether potential acquirors, target companies or bystanders).

In July 1983, the Advisory Committee issued its Report. In presenting the Report, Advisory Committee Chairman Dean LeBaron emphasized (i) the Advisory Committee's conclusion that tender offers are not beneficial or harmful per se, to the economy or securities markets generally, or to issuers or shareholders in particular; (ii) the Committee's reliance on competitive markets as the ultimate regulator; (iii) the Committee's desire to promote private investment systems and not hamper capital formation by heavy reliance on rulemaking; (iv) the Committee's goals of protection of shareholders and disclosure of meaningful information to all investors; and (v) the Committee's preference for solutions characterized by flexibility, simplicity and lower costs.

The Advisory Committee's Report contained 50 recommendations ranging from more general recommendations to specific suggestions for amendments to existing rules. The Committee endorsed the Williams Act's premise that takeover regulation should not be designed to favor either the bidder or the target. Moreover, the Committee affirmed the Williams Act's stated purpose that the intent of takeover regulation should be the protection of shareholders and the effectiveness and integrity of the securities markets. While the Committee did recommend changes in federal regulation of both bidders and targets, it sought essentially to preserve the basic foundations of the current regulatory scheme. The Committee concluded that takeover regulation should aim to achieve a reasonable balance, recognizing that takeovers take place in a national securities market.

C. Commission Response to Advisory Committee Recommendations

In March 1984, the Commission considered its staff's analysis of the Advisory Committee's recommendations. At that time, the Commission concluded that certain additional shareholder protection measures were necessary, including the restriction of certain tactics. The Commission emphasized, however, that it did not endorse undue intrusion into state corporate law.

Overall, as explained in its March 28, 1984 testimony before the House Subcommittee on Telecommunications, Consumer Protection, and Finance, the Commission agreed with the vast majority of the

Advisory Committee's recommendations. 41/ In particular, the Commission agreed with 34 recommendations, qualified 13, disagreed with 6, and concluded that 3 required further study. 42/

The Commission identified 14 of the Advisory Committee's recommendations as appropriate for implementation through existing rulemaking authority. 43/ The Commission has taken final action regarding four of these fourteen recommendations 44/ and has also taken final action on Recommendation 47, which it identified as appropriate for further study. 45/ The Commission has also issued rulemaking proposals responsive to one additional recommendation. 46/ The Commission's staff is analyzing the remaining recommendations.

Additionally, the Commission determined that six of the recommendations 47/ required federal legislation. The Commission submitted

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41/ Attached as Exhibit E is the Commission's written statement submitted at these hearings ("March 1984 Testimony"), which includes the text of each Advisory Committee recommendation.

42/ March 1984 Testimony at 6. Because some of the recommendations have subparts, these numbers total more than 50.

43/ Recommendations 5, 11, 12, 17, 18, 20, 22, 29, 37(b), 39(b), 44, 45, 46, and 48.

44/ Recommendations 44, 45, 46, 48.

45/ Recommendation 47.

46/ Recommendation 11.

47/ Recommendations 13, 21, 38, 39(a), 41 and 43.

a legislative proposal to Congress on May 21, 1984, dealing with those recommendations, which is discussed below at Section IV. 48/

Specifically, the Commission implemented Recommendations 44 and 46 by amending Rule 10b-4 (i) to prohibit hedged tendering and (ii) to prohibit a tendering security holder from tendering the same securities to more than one partial offer at the same time. In response to Recommendation 45, the Commission published for comment a proposal to amend Rule 10b-4 to require that all securities tendered pursuant to a guarantee of delivery be delivered to the offeror or the offeror's agent. 49/ After reviewing the comments received, the Commission, on February 21, 1985, decided not to adopt this proposed amendment to Rule 10b-4. The Commission concluded that the existing guarantee process was working in a satisfactory matter. At this same meeting, the Commission took action on Recommendation 47, one of the three recommendations it had identified as appropriate for further study. The Commission adopted amendments to Rule 10b-4 to require tendering persons to exclude from their "net long position" those

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48/ The Commission had previously transmitted to Congress, on April 23, 1984, a legislative proposal entitled "The Shareholder Communications Act of 1984." This proposal, which would authorize the Commission to regulate the proxy processing activities of banks, associations and other entities in the same fashion as the Commission currently regulates broker-dealers, was based on the recommendation of the Advisory Committee on Shareholder Communications in 1982, which was also included as Recommendation 21 of the Advisory Committee on Tender Offers.

49/ Release No. 34-21049 (June 15, 1984).

shares underlying certain standardized call options written after the tender offer's announcement. 50/

In accordance with Recommendation 48, the Commission adopted Rule 17Ad-14. 51/ The Rule requires transfer agents, acting on behalf of bidders as tender agents, to establish and maintain special accounts with all qualified registered securities depositaries holding the subject company's securities. These accounts will permit depositary participants to move securities to and from the tender agent by book entry and thereby reduce processing costs.

With respect to Recommendation 11, in May 1984 the Commission proposed for comment a new form (Form S-4) to be used to register securities under the 1933 Act in connection with certain business combination transactions. 52/ This proposal would apply principles of the integrated disclosure system to the merger and exchange offer context.

Also in May 1984, the Commission published for comment a proposed form that could be used by certain foreign private companies to register securities in business combination transactions encompassed by proposed Form S-4. 53/ The public commentators expressed

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50/ Release No. 34-21782 (February 28, 1985).

51/ Rule 17Ad-14 was actually adopted prior to the issuance of the Committee's report.

52/ Securities Act Release No. 33-6534 (May 9, 1984).

53/ Securities Act Release No. 33-6535 (May 9, 1984).

general support for both of these proposals and the Commission expects to consider both of them in the near future.

The Commission had reservations about Recommendations 14 54/ and 16 55/ and determined that they required further study. Recommendation 14 essentially proposed that any acquisition resulting in total ownership of over 20% of the voting power of an issuer be made by tender offer. Recommendation 16 proposed that a partial offer have a longer minimum offering period than a bid for all shares. The Commission issued a concept release relating to these types of acquisition programs. 56/ The Commission solicited public comment on the threshold question of whether partial and two-tier bids are harmful to target company shareholders and on the issues raised by, and alternatives to, such offers. Eighteen comment letters were received in response to the Commission's solicitation. At the request of the Senate Banking Committee, the Commission provided a summary of the comments, as well as copies of the comment letters. With respect to two-tier offers, of the 65 tender offers commenced during the first five months of fiscal year 1985, only one was a two-tier offer.

With respect to Recommendation 14, this Subcommittee previously requested the Commission's views on a related proposal which would require a person acquiring 20% of a company's stock to make

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54/ See March Testimony at 14.

55/ Id. at 15.

56/ Securities Exchange Act Release No. 34-21079 (June 21, 1984).

a tender offer for all the shares on identical terms. The Commission's response letter expressed opposition to this proposal. The Commission stated that adoption of this proposal would entrench incumbent management and inhibit friendly and contested partial acquisitions, including equity investments of over 20% and majority-owned subsidiaries. The Commission also expressed its continuing opposition to extension of the current 20 business day minimum offering period. Finally, the Commission expressed its opposition to a proposal which would limit holders of 5% to 90% of an issuer's common stock to 5% of the vote for 3 years and would require management to submit to its shareholders, and take no action to frustrate, any unconditional cash offer for all the issuer's stock at twice its current market price. The Commission stated that such a proposal would also entrench incumbent management, would inhibit, if not preclude, partial acquisitions, whether friendly or unfriendly, and would deprive investors of important rights of ownership. The Commission noted that the 5% voting power limitation would seriously impair shareholders' ability to take issue with management through the proxy process. The Commission also concluded that the voting rights of corporate securities is a fundamental issue of state corporate law and that it did not support federal preemption of such rights for this purpose. 57/

57/ A copy of Chairman Shad's letter of February 22, 1985 is attached as Exhibit F. Three of the other Commissioners concurred in the views expressed in this letter. One Commissioner took exception to the statements made concerning partial acquisitions, particularly hostile partial tender offers.

IV. Commission 1984 Legislative Proposal

As noted, the Commission submitted a legislative proposal to Congress concerning six of the Advisory Committee recommendations. The Tender Offer Reform Act of 1984 would have amended Sections 13(d) and 14 of the Securities Exchange Act of 1934 as follows:

(a) permit the Commission to reduce the 10-day filing requirement under Section 13(d) of the Securities Exchange Act of 1934;

(b) prohibit "golden parachutes" and defensive issuance or reacquisition of securities by target companies during tender offers that meet specific criteria; and

(c) prohibit "greenmail" unless approved by a majority of the issuer's aggregate voting securities or unless an equal offer is made to all shareholders.

The Act was introduced in the House of Representatives as H.R. 5693 and in the Senate as S.2784. Provisions of the Commission proposal dealing with "golden parachutes" and "greenmail" were also added by the Senate Banking Committee to S.2851, the banking bill passed by the Senate in September 1984. The House did not pass this measure. The Senate Banking Committee also held hearings in October 1984 on several proposals in the tender offer area. 58/

The Commission opposed H.R. 5693 as amended and ordered reported by the House Energy and Commerce Committee. The Commission's

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58/ A copy of the Commission's October 2, 1984 testimony before the Senate Banking Committee is attached as Exhibit G.

objections to the bill, as amended, were based on three aspects of the bill. These were (1) the amendment to the disclosure provisions of Section 13(d) that would require disclosure of the impact of the purchaser's plans on the issuer's community; (2) the statutory mandate of a minimum offering period of 40 days for a tender offer; and (3) the absence of limitation on the kind of tender offer that would trigger restrictions on defensive tactics. The House did not act on this proposal before adjournment.

V. Conclusion

At the present time, the Commission does not intend to reintroduce its 1984 legislative proposal on tender offers. The Commission is evaluating its position in the tender offer area in light of continuing evolution in practices in this area since its proposal was submitted to Congress in May 1984.

For example, in the greenmail area, it appears that such transactions may be declining because of concern on the part of issuers that, by purchasing the shares held by one potential bidder, they will become the target of others. Also, some issuers have adopted, in their corporate charter, language similar or identical to the Commission's 1984 proposal dealing with greenmail. Finally, portions of the Deficit Reduction Act of 1984 (P.L. 98-369), enacted in July 1984, may affect the practice of greenmail. Prior to the enactment of the Deficit Reduction Act, when a corporation borrowed funds to, for example, secure a "toe-hold" position in a company, it could deduct the interest paid on the loan and 85% of any dividends received from the target. Under the Deficit Reduction Act, to the extent that stock

purchased with borrowed funds pays such dividends, the 85% corporate dividends received deduction is reduced by a percentage related to the amount of debt incurred to purchase the stock. This may have the effect of making greenmail and other "toe-hold" acquisitions which utilize borrowed funds more expensive.

Other aspects of tender offer practices may be affected by the Deficit Reduction Act. This bill also permits lenders to ESOP's to exclude from income 50% of the interest income received on the loan, if the proceeds of the loan are used by the ESOP to acquire employee securities. This may enhance the ability of ESOP's to structure leveraged buy-outs.

The Deficit Reduction Act also includes restrictions which make "golden parachute" payments, as defined in the Act, (i) subject to a 20% excise tax payable by the receiving employee and (ii) non-deductible by the employer. Since the Deficit Reduction Act is relatively new, its effects on tender offer practices cannot yet be determined.

Another area which is continuing to evolve concerns the scope of state law's ability to regulate tender offers and tender offer practices. For example, a recent decision of the Delaware Chancery Court in Moran v. Household International, Inc., C.A. No. 7730 (Del. Ch., January 29, 1985), upheld the adoption of a "poison pill" plan by Household International's directors. This case is currently on appeal and the Commission has filed a brief, amicus curiae, urging that the decision of the court below be reversed.

In another recent decision, the Court of Appeals for the Eighth Circuit construed the validity of the Minnesota Corporate Takeover Act, 1984 Minn. Laws ch. 80B, which regulates the conduct of tender offers within Minnesota. The Eighth Circuit upheld some portions of the Minnesota statute while invalidating others. Cardiff Acquisitions, Inc. v. Hatch, No. 84-5210 (8th Cir., November 29, 1984).

Adoption of antitakeover charter amendments has also grown in popularity. Serious concerns have been expressed about such provisions. The New York Stock Exchange Subcommittee on Shareholder Participation and Qualitative Listing Standards has recently recommended to the Board of the New York Stock Exchange that an issuer should not have its securities delisted because of the adoption of charter provisions creating two classes of common stock having differing voting rights, if certain conditions are met. If the Board of the Exchange approves these proposed changes, such changes would have to be submitted to the Commission for its decision.

On February 20, 1985, the Commission held an "Economic Forum on Tender Offers". The Commission received valuable input from economists and members of the business community, which the Commission believes will prove useful in its continuing review of the tender offer area. The Commission looks forward to working with the members of the Subcommittee as the debate over tender offer issues continues.

EXHIBIT A

Total Number and Dollar Volume of Tender Offers, 1956-1984

Year*	Number of Tender Offers	Dollar Volume of Tender Offers (in billions)
1956	2	N.A.
1957	0	N.A.
1958	3	N.A.
1959	4	N.A.
1960	7	N.A.
1961	8	N.A.
1962	10	N.A.
1963	21	N.A.
1964	12	N.A.
1965	105	N.A.
1966	77	N.A.
1967	113	N.A.
1968	115	N.A.
1969	70	N.A.
1970	34	N.A.
1971	43	N.A.
1972	50	N.A.
1973	75	N.A.
1974	105	N.A.
1975	113	N.A.
1976	100	N.A.
1977	162	N.A.
1978	179	$10.2
1979	147	9.0
1980	104	8.5
1981	205	23.8
1982	116	25.4
1983	92	10.1
1984	121	45.7

Source: Douglas Austin and Associates, 1956-1964; Professors Samuel L. Hayes and Russell A. Taussig, 1965-1966; W. T. Grimm & Co., 1967-1968; SEC Division of Corporation Finance, 1969-1984.

*Data are for calendar years, 1956-1964; fiscal years 1965-1984.

EXHIBIT B

Below is summarized some data from a paper by Gregg Jarrell and Michael Bradley entitled, "The Economic Effects of Federal and State Regulation of Cash Tender Offers," Journal of Law and Economics (October 1980), pp. 371-407. This study empirically examines tender offer premiums, pre- and post-Williams Act.

Jarrell and Bradley find the following results on tender premiums (Table 1, p. 389):

Subsample	No.	Tender Premium	Pct. of Shares Purchased	Back-End Market Premiums
Pre Williams Act	47	32.4%	42.1%	20.4%
Post Williams Act				
Federal Regulation	94	52.8	61.2	32.8
Federal and State Regulation	20	73.1	71.8	35.3

Their sample consists of 161 targets acquired during the period July 1962 to December 1977. The tender premium was computed to be the per-share tender price expressed as a percentage of the target's stock price 40 days prior to the offer, adjusted for stock splits and dividends. The results strongly suggest that the Williams Act increased tender premiums by 20 percentage points and the state tender offer laws increased tender premiums by another 20 percentage points. These differences are statistically significant. Note that the percentage of shares purchased also increased after the Williams Act. Finally, back-end market premiums to target shareholders increased from 20.4% before the Williams Act to 32.8% after the Williams Act. Where the tender offer was also regulated by state law, back-end premiums are 35.3%.

Jarrell and Bradley also examined returns to bidders, before and after the Williams Act. Because of data limitations at the time of their study, they were able to examine these returns for only 88 bidders. They found the following resuls:

Subsample	No.	Excess Returns
Pre Williams Act	28	10.5%
Post Williams Act		
Federal Regulation	51	5.6
Federal & State Regulation	9	2.2

Although these results do not include offers from 1977-84, they do suggest that in large part the gains to target shareholders associated with the Williams Act are at the expense of bidder shareholders. In fact, it has increased the targets' share of the gains from these corporate combinations and decreased the bidders' share, on average. They speculate that this has occurred because Federal (and State) tender offer regulations provided critical time for target defensive strategies, enhanced the opportunities for litigious defenses, and helped stimulate auction-style takeovers (bidding wars). The data from Bradley, Desai, and Kim, "Specialized Resources and Competition in the Market for Corporate Control," University of Michigan Working Paper (1982), shows that post-Williams Act takeovers are much more likely to have auction-style bidding wars than are unregulated tender offers.

EXHIBIT C
Enforcement Actions
Relating to Changes in Corporate Control
July 1981 - February 1985

The Commission has initiated 30 enforcement actions involving changes in corporate control since July 1981. Nineteen of those cases involved alleged violations of the beneficial ownership reporting provisions, while seven cases involved alleged violations of the tender offer provisions, and seven cases involved alleged violations of the proxy violations. One case involved violations of Section 10(b) and Rule 10b-13. (The total number exceeds 30 because some cases involved violations of more than one section.)

SEC v. James H. McElroy, et al., Civil Action No., 84-2223 D.C.C., filed July 19, 1984 [Lit. Rel. No. 10462]

Alleged failure to make required tender offer recommendation filings and to comply with proxy rules concerning an attempt to organize shareholders in opposition to a tender offer for shares of Gulf Corporation, late filings or non-filings of proxy solicitation materials, and failure to disclose material facts concerning the defendants' improper activities in a prior similar tender offer contest.

SEC v. Greater Columbia Bancshares, Inc., Civil Action No. 84-C-572 (W.D. Wisc., filed July 17, 1984 [Lit. Rel. No. 10475]

Alleged purchases by defendant of stock of the First National Bank of Portage through officers and directors of both the defendant and First National in a manner otherwise than pursuant to the terms of two separate exchange ofers made by the defendant for First National stock, contributing to the apparent defeat of a competing cash tender offer.

SEC v. Paul Reichart, Civil Action No. 84-1671 (D.D.C., filed May 31, 1984) [Lit. Rel. No. 10404]

The Commission alleged that a solicitation made by an individual of approximately 73 shareholders of Columbia Management Co., Inc. constituted a tender offer in violation of Commission tender offer and reporting requirements.

SEC v. Carter Hawley Hale Stores, Inc., Civil Action No. 84-3149 (C.D.Cal., filed May 2, 1984) [Lit. Rel. No. 10366]

Purchase by company of 50% of its then outstanding shares in six trading days, in response to a third party tender offer, alleged to be a "tender offer" that should have been made in compliance with Rule 13e-4 of the Securities's Exchange Act of 1934. Following a hearing on the Commission's motion for a preliminary injunction the court, which had entered a temporary restraining order on the Commission's earlier motion, found that Carter Hawley's repurchases did not constitute a tender offer and declined to enter a preliminary injunction. The decision is being appealed to the Ninth Circuit.

In the Matter of Harvey Katz, et al., Securities Exchange Act Release No. 20893 (April 25, 1984)

Alleged failure to file timely and accurately Schedule 13D statements of beneficial ownership of Bradford National Corporation.

SEC v. Mesa Petroleum Co., Civil Action No. H-84-1717 (S.D. Texas, filed April 16, 1984) [Lit. Rel. No. 10343]

Alleged failure to disclose in Schedule 13D amendments consideration of a plan or proposal to make a tender offer for majority voting control of Gulf Corporation, and substantial steps to seek financing in furtherance thereof.

SEC v. Gerhard Haase, Civil Action No. 84-0287 (D.D.C., filed January 26, 1984) [Lit. Rel. No. 10268]

Primarily a case involving alleged manipulative activity in trading in the securities of Damon Creations, Inc., the action included allegations of failure to file reports of beneficial ownership of over 5% of the securities of Damon and two other companies, and to provide updated disclosure concerning beneficial ownership of the Driver-Harris Company.

SEC v. Enterprise Technologies, Inc., Civil Action No. 84-0181 (D.D.C., filed January 18, 1984) [Lit. Rel. No. 10264]

Proxy solicitation materials allegedly did not disclose that company had agreed in principle that Enterprise would issue to the principals of a private company a controlling interest in Enterprise's common stock in exchange for all of the stock of the private company and that representatives' of the private company would acquire control of Enterprise's board of directors.

SEC v. Dorchester Gas Corporation, Civil Action No. 84-0055 (D.D.C., filed January 9, 1984) [Lit. Rel. No. 10255]

Proxy solicitation material which proposed amending the company's articles of incorporation to include three anti-takeover measures, allegedly failed to disclose leveraged buy-out plan by members of management, which plan was under way during the time period in which proxies were being solicited.

The litigation release announcing the injunctive action included a statement of the Commission emphasizing the need for adequate and accurate disclosure with respect to anti-takeover and other defensive measures.

SEC v. Lenny Steven Smith and The Veta Grande Companies, Inc., Civil Action No. 83 Civ. 3805 (D.D.C., filed December 21, 1983) [Lit. Rel. No. 10242]

Alleged failure to disclose in timely Schedule 13D filings purchases and sales of the common stock of Seiscom Delta, Inc., and the sources of funds used in making certain of such purchases, in connection with acquiring approximately 20% of Seiscom Delta's outstanding stock.

SEC v. Douglas R. Massey, Civil Action No. CV-83-C-28045 (N.D.Ala., filed November 17, 1983) [Lit. Rel. No. 10223]

Solicitation materials for proxies and tender of common stock of Jefferson National Equities Corporation allegedly failed to disclose, among other things, true identity of soliciting purchasers and that a primary purpose of the tender offer was to oust current management of the company.

In the Matter of Heights Finance Corporation and Certain Directors, Securities Exchange Act Release No. 20354 (November 7, 1983)

Alleged failure of company, the subject of a tender offer, to disclose beneficial ownership of over 5% of the outstanding common stock by a company with which Heights had done business for many years; and failure of certain directors to report beneficial ownership of over 5% outstanding common stock.

SEC v. TriState Holding Group, Inc., Civil Action No. 83-0837 (D.D.C., filed March 24, 1983) [Lit. Rel. Nos. 9937, 9995]

Alleged failure to disclose in communications to shareholders of Titan Group, Inc. and of Wieboldt Stores, Inc., activities by a group of dissident shareholders such as instituting litigation, causing adverse publicity, making an exchange offer and waging proxy contests and thereafter offering to terminate the activities in exchange for payments of money.

SEC v. Canal-Randolph Corp., Civil Action No. 83-112 (D.Del., filed March 11, 1983) [Lit. Rel. No. 9909]

Alleged failure by company and its beneficial owners to disclose extent of ownership and control of company by beneficial owners.

In the Matter of Montagu Investment Management, Ltd., Securities Exchange Act Release No. 19591 (March 10, 1983)

Alleged failure to disclose timely and completely required information concerning beneficial ownership of Canal-Randolph Corporation and one other company. The Commission in its findings, emphasized the obligation of all persons, including foreign persons, to comply with the beneficial ownership provisions of the Exchange Act.

SEC v. Canran Associates, Inc., Civil Action No. 83-113 (D.Del., filed March 1, 1983) [Lit. Rel. No. 9908]

Alleged failure to disclose plans for tender offer for Canal-Randolph Corporation.

SEC v. Instrument Systems Corportion, Civil Action No. 83-0122 (D.D.C., filed January 19, 1983) [Lit. Rel. No. 9871]

Alleged failure to file required schedules and disclose information concerning offers by company to exchange common stock for outstanding convertible debentures.

SEC v. Walco National Corp., Civil Action No. 82-3194 (D.D.C., filed November 9, 1982) [Lit. Rel. No. 9798]

Primarily a case alleging failure to disclose issuer related party transactions; allegations included failure to disclose intent to acquire controlling interest in General Steel Industries, Inc. in which Walco owned over 5% common stock.

SEC v. Hunt, Civil Action No. 82-1931 (D.D.C., filed July 13, 1982) [Lit. Rel. No. 9716]

Alleged failure to disclose adequately extent of beneficial ownership of Bache Group, Inc.

SEC v. Brady Energy Corp., Civil Action No. 82-1910 (D.D.C., filed July 12, 1982) [Lit. Rel. No. 9715]

Primarily a case involving inadequate disclosure relating to public offering; allegations included failure to disclose attempt, following public offering, to sell approximately 60% of outstanding common stock to a Bahamian corporation.

SEC v. Norcen Energy Resources, Civil Action No. 82-1684 (N.D.Ohio, filed July 1, 1982) [Lit. Rel. No. 9719]

Alleged failure to disclose plans by major beneficial owner of the Hanna Mining Company to increase significantly amount of common stock owned and gain, through stock ownership, representation on board.

SEC v. Maryland Old Line Corp., Civil Action No. 82-1407 (D.D.C., filed May 21, 1982) [Lit. Rel. No. 9678]

Alleged failure to disclose defensive anti-takeover measures.

In the Matter of Terry P. McKenna, Securities Exchange Act Release Nos. 18749 (May 17, 1982), 18940 (August 9, 1982)

Alleged failure to disclose acquisition of options to purchase 30% of common stock of Maryland Old Line Corp. by special counsel to company in connection with anti-takeover activities.

SEC v. Ashkenazy, Civil Action No. 82-1799 (C.D.Cal., filed April 13, 1982) [Lit. Rel. Nos. 9645, 9729]

Alleged failure to disclose beneficial ownership of Financial Federation, Inc., and scheme to achieve representation on board of directors and substantial voice in company affairs.

SEC v. Swanton Corporation, Civil Action No. 82-0014 (D.D.C., filed January 5, 1982) [Lit. Rel. No. 9542]

Primarily an issuer financial disclosure case; included separate cause of action alleging untimely and misleading filing of reports of beneficial ownership of company Swanton was attempting to acquire.

SEC v. Bayswater Realty & Capital Corp., Civil Action No. 81-3203 (D.D.C., filed December 30, 1981) [Lit. Rel. No. 9540]

Alleged failure to disclose adequately attempts to seek representation on boards of directors of Saxon Industries, Inc. and Hammermill Paper Co., including agreement with Saxon to abandon plans to join board after Saxon repurchased at a substantial premium stock of the company owned by Bayswater Group.

In the Matter of Paine Webber, Jackson & Curtis, Inc., Securities Exchange Act Release Nos. 18318 (December 9, 1981), 19479 (February 2, 1983)

Following a contested proceeding, the Commission found that an acquisition of 9.9% of outstanding shares of common stock of Diamond International Corporation, during a third party tender offer for the company, constituted a tender offer under the Williams Act.

SEC v. Grumman Corp., Civil Action No. 81-3685 (E.D.N.Y., filed November 9, 1981) [Lit. Rel. No. 9493]

Alleged failure by company to disclose defensive anti-takeover measures. In its decision entered June 18, 1984, the court found Grumman failed to disclose the understanding between it and the Madison Fund (a public investment company') with reference to the purchase of Grumman stock and Grumman s indemnification of trustees of its Pension Trust, but declined to enter injunction. The court found that Grumman had adequately stated that the purpose of stock purchases by the Pension Trust and Grumman was to defeat another party's tender offer.

SEC v. Gerhard Haase, Civil Action No. 81-1741 (D.D.C., filed July 27, 1981) [Lit. Rel. No. 9404]

Alleged failure to disclose extent of beneficial ownership of securities of Driver Harris Company, extent of purchases made through diverse accounts controlled by defendant, and attempts to maintain, dominate and control market in company's common stock.

SEC v. Diagnostic Data, Inc., Civil Action No. 81-1627 (D.D.C., filed July 15, 1981) [Lit. Rel. No. 9394]

Alleged failure to disclose extent of beneficial ownership and intentions concerning representation on board of directors.

March, 1985

EXHIBIT D

Securities and Exchange Commission
Office of General Counsel

AMICUS BRIEFS RELATING TO CHANGES
IN CORPORATE CONTROL

The Commission expressed its views as amicus curiae on various issues relating to changes in corporate control in the thirteen cases discussed below. In eight of these cases the Commission supported the existence of an implied private right of action for equitable relief under the provisions of the Williams Act and discussed the authority of district courts to fashion appropriate relief in such cases. The Commission addressed other issues relating to the regulation of tender offers under the Williams Act in five cases. One of the latter group of cases also involved issues relevant to proxy contests.

Voisin v. Bartell Media Corp.
(S.D.N.Y., letter sent July, 1981) (letter to district court judge in response to her request for the Commission's views)

The Commission took the position that the statutory merger at issue in the case was not a tender offer subject to Sections 14(d) and 14(e) of the Exchange Act. The court so held. [1981-1982] Fed. Sec. L. Rep. (CCH) ¶ 98,486 (S.D.N.Y. 1982).

Edgar v. MITE Corp.
(Supreme Court, brief filed July, 1981)

The Commission argued that the Illinois Business Take-over Act violated the Commerce Clause and was preempted by the Williams Act. The Supreme Court held that the statute violated the Commerce Clause. Three of the six Justices reaching the merits of the case also found that the statute was preempted by the Williams Act. 457 U.S. 624 (1982).

Empire v. Ashcroft
(W.D. Mo., brief filed August, 1981)

The Commission argued that the Missouri takeover statute was preempted by the Williams Act. The court so held. 524 F. Supp. 898 (W.D. Mo. 1981).

General Steel Industries, Inc. v. Walco National Corp.
(8th Cir., brief filed December, 1981)

The Commission argued that a district court has authority, in a private action under Section 13(d) of the Exchange Act, to order equitable remedies in addition to corrective disclosure. This case was settled before the 8th Circuit rendered its decision.

Jacobs v. Pabst Brewing Co.
(D. Del., brief filed June, 1982)

The Commission argued that an implied private right of action exists under Section 13(d) of the Exchange Act in favor of shareholders. The court so held. 549 F. Supp. 1050 (D. Del. 1982).

Hanna Mining Co. v. Norcen Energy Resources Limited
(N.D. Ohio, brief filed June, 1982)

The Commission argued that the issuer corporation and its shareholders have a private right to action under Section 13(d) of the Exchange Act to seek equitable relief; that Section 14(e) of the Exchange Act applies prior to the public announcement of a tender offer; and that the district court in a private action can order other equitable remedies in addition to corrective disclosure. The court so held. 574 F. Supp 1172 (N.D. Ohio 1982).

Liberty National Insurance Holding Co. v. Charter Co.
(11th Cir., brief filed October, 1982)

The Commission argued that an implied private right of action for equitable relief exists under Section 13(d) of the Exchange Act in favor of the issuer corporation when it seeks (i) injunctive relief to halt or correct alleged violations of Section 13(d) and (ii) other equitable relief, including divestiture. The court held that a private right of action for divestiture did not exist in favor of issuers under Sections 10(b), 13(d), 14(d) and 14(e). 734 F.2d 545 (11th Cir. 1984).

Sharon Steel Corp. v. Whaland
(S. Ct. N.H., brief filed November, 1982) (on remand from the Supreme Court following its decision in Edgar v. MITE)

The Commission argued that the New Hampshire takeover statute violated the Commerce Clause and was preempted by the Williams Act. The Supreme Court of New Hampshire held, on Sept. 30, 1983, that the statute violated the Commerce Clause. The Court did not rule on the Williams Act issue. 466 A.2d 919 (N.H. 1983).

San Francisco Real Estate Investors v. Real Estate Investment Trust of America (1st Cir., brief filed December, 1982)

The Commission argued: (1) that a private right of action exists under Sections 13(d), 14(d) and 14(e) of the Exchange Act to seek injunctive relief to halt or correct alleged violations of those sections, as well as other equitable relief; and (2) that a district court has authority in a private action to order other equitable remedies in addition to corrective disclosure. The court stated that it did not need to reach the issue of the existence of a private right of action. It adopted the Commission's test on the district court's authority. 701 F.2d 1000 (1st Cir. 1983).

Indiana National Corp. v. Rich
(7th Cir., brief filed January, 1983)

The Commission argued that an issuer corporation has a private right of action for equitable relief under Section 13(d). The court so held. 712 F.2d 1180 (7th Cir. 1983).

Gearhart Industries, Inc. v. Smith International, Inc.
(5th Cir., brief filed July, 1984)

The Commission took the position that a district court has authority in a private action, under appropriate circumstances, to order traditional equitable remedies, in addition to corrective disclosure, for violations of Section 13(d) of the Exchange Act. The court of appeals agreed with the Commission's position, and also held that a private right of action is available to an issuer corporation to obtain equitable relief for violations of Sections 13(d) and 14(e) of the Exchange Act, an issue not addressed by the Commission's brief. 741 F.2d 707 (5th Cir. 1984).

Florida Commercial Banks, Inc. v. Hugh F. Culverhouse, Sr.
(11th Cir., brief filed March, 1985)

The Commission took the position that the Liberty decision of the Eleventh Circuit should be limited to requests for disgorgement and that to the extent a complaint by an issuer requests corrective disclosure and an order enjoining a tender offer for a period sufficient to allow the corrective disclosure to be considered by investors, the complaint can state a claim under Sections 13(d), 14(d) and 14(e).

Moran v. Household International Inc.
(Supreme Court of Delaware, filed March 19, 1985)

The Commission argued that a "poison pill" rights plan adopted by Household as an anti-takeover defense would bar all hostile takeovers for Household, would deter proxy contests by Household shareholders, would entrench Household's management, and thus was not in the interests of Household's shareholders and should not be sustained. The case is presently pending before the court (No. 37, 1985).

Statement of John S.R. Shad
Chairman of the Securities and Exchange Commission
Before Hearings of the House Subcommittee on
Telecommunications, Consumer Protection, and Finance
Concerning the Recommendations of the Securities and Exchange
Commission Advisory Committee on Tender Offers

Wednesday, March 28, 1984

Chairman Wirth and Members of the Subcommittee:

I. Introduction

The SEC appreciates this opportunity to testify on the Report of Recommendations of the Commission's Advisory Committee on Tender Offers. 1/ The report addresses fundamental policy issues in the tender offer area.

II. Origins and Objectives of the Tender Offer Advisory Committee

The Commission established the Tender Offer Advisory Committee on February 25, 1983, to atudy the fundamental changes that

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1/ The Advisory Committee's Recommendations and the Commission's positions and proposed actions are included herein.

acquisition practices have undergone since the Williams Act was adopted in 1968. In view of substantial changes in the size, nature and complexity of such transactions, the Commission concluded that it was appropriate to undertake a major reexamination of the tender offer process and to obtain recommendations for appropriate legislative and regulatory changes.

The Advisory Committee was requested to review tender offer practices and regulations and propose specific regulatory and legislative improvements for the benefit of all shareholders (i.e. shareholders of all corporations, whether potential acquirors, target companies or bystanders).

The eighteen distinguished members of the Advisory Committee included fourteen members of the business and financial community, and the legal and accounting professions, who have been actively involved in numerous tender offers as institutional investors, bidders, targets, arbitrageurs, investment and commercial bankers, attorneys and accountants, two academicians who have written extensively on the subject, a former Supreme Court Justice and a former state securities commissioner. 2/

2/ See Exhibit A for the members of the Advisory Committee.

III. Overview of Advisory Committee Meetings and Conclusions

All meetings of the Advisory Committee were open to the public. At its first meeting on March 18, 1983, the Advisory Committee reached agreement on the appropriate scope of its review, stating that it would consider the whole spectrum of acquisition techniques, but would focus on those issues which are common to acquisitions of control through purchases of equity securities from investors. 3/ The Advisory Committee formed six working subcommittees, which held numerous informal meetings between the meetings of the full Committee.

The Advisory Committee held its second and third meetings on April 15 and May 13 in New York City. At these meetings each of the working groups reported on their activities and on their meetings with representatives of various government agencies, including Chairman Miller of the Federal Trade Commission, Chairman Volcker of the Federal Reserve Board and representatives of the Department of the Treasury. The Committee also discussed the tender offer experience and regulatory response in Great Britain with the Director-General of the London Panel on Take-Overs and Mergers. On June 2 the Advisory Committee held

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3/ See Section I of the Advisory Committee's Agenda of Issues, which is attached as Exhibit B.

a full day meeting in New York City for the purpose of receiving presentations from commentators and other interested parties, including Assistant Attorney General William Baxter.

At the Advisory Committee meeting in Washington D.C. on June 10, 1983, the Committee considered and reached agreement on the recommendations to be included in its final report. Committee members presented the report and discussed the recommendations with the Commission and senior staff on July 8, 1983. The Commission promptly delivered copies of the report to the members of this Subcommittee and the Senate Banking Committee.

The recommendations of the Advisory Committee were organized into the following categories: Economics of Takeovers and their Regulation, Objectives of Federal Regulation of Takeovers, Regulation of Acquirors of Corporate Control, Regulation of Opposition to Acquisition of Control, Regulation of Market Participants, and Interrelationship of Various Regulatory Schemes. In presenting the report, Advisory Committee Chairman Dean LeBaron emphasized (i) the Advisory Committee's reliance on competitive markets as the ultimate regulator; (ii) the Advisory Committee's desire to promote private investment

systems and not hamper capital formation by heavy reliance on rulemaking; (iii) the Committee's goal of disclosure of meaningful information to all investors; and (iv) the Committee's preference for solutions which are characterized by flexibility, simplicity and lower costs. 4/ The Commission endorses those principles.

IV. Commission Response to Advisory Committee Recommendations

The Commission commends the Advisory Committee for its outstanding efforts. Although faced with a demanding schedule, the Advisory Committee performed a comprehensive review of the acquisition process and presented the Commission with fifty thoughtful and comprehensive recommendations, including recommendations for legislative and regulatory changes.

The Commission staff has been engaged in a detailed analysis of the Committee's recommendations since they were received. The Commission considered the staff's analysis of the Committee's recommendations at an open meeting on March 13, 1984.

4/ See attached July 28, 1983 letter from Dean LeBaron, Chairman, Advisory Committee on Tender Offers, to Securities and Exchange Commission Chairman John S.R. Shad, transmitting the Report of Recommendations of the Advisory Committee on Tender Offers (Exhibit C).

Of the recommendations, the Commission agreed with thirty-four, 5/ qualified thirteen, 6/ disagreed with six 7/ and concluded that three require further study. 8/ Because some of the recommendations have subparts, these numbers total more than fifty.

Of the recommendations, the Commission concluded that six 9/ require federal legislation and fourteen 10/ can be implemented under the Commission's existing rulemaking authority. No formal action is required on the remaining recommendations endorsed by the Commission.

The Commission's specific positions on each Committee recommendation are as follows:

5/ Recommendations 1, 3, 5, 6, 7, 8, 9(a), 9(c), 9(d), 9(e), 10, 11, 20, 21, 22, 23, 24, 25, 26, 28, 29, 30, 31, 32, 34, 37(b), 39(b), 43, 44, 45, 46, 48, 49, 50.

6/ Recommendations 2, 4, 9(b), 12, 13, 17, 18, 33, 35, 36, 38, 41, 42.

7/ Recommendations 15, 19, 27, 37(a), 39(a), 40.

8/ Recommendations 14, 16, 47.

9/ Recommendations 13, 21, 38, 39(a), 41, 43.

10/ Recommendations 5, 11, 12, 17, 18, 20, 22, 29, 37(b), 39(b), 44, 45, 46, 48.

COMMITTEE RECOMMENDATIONS AND THE COMMISSION'S POSITIONS AND CONTEMPLATED ACTIONS

I. Economics of Takeovers and their Regulation

1. The purpose of the regulatory scheme should be neither to promote nor to deter takeovers; such transactions and related activities are a valid method of capital allocation, so long as they are conducted in accordance with the laws deemed necessary to protect the interests of shareholders and the integrity and efficiency of the capital markets.

   The Commission agrees with this general proposition. It requires no specific action.

2. There is no material distortion in the credit markets resulting from control acquisition transactions, and no regulatory initiative should be undertaken to limit the availability of credit in such transactions, or to allocate credit among such transactions.

   The Commission has limited expertise in this area, but agrees with this general proposition. It requires no specific action.

II. Objectives of Federal Regulation of Takeovers

3. Takeover regulation should not favor either the acquiror or the target company, but should aim to achieve a reasonable balance while at the same time protecting the interests of shareholders and the integrity and efficiency of the markets.

The Commission agrees with this general proposition. It requires no specific action.

4. Regulation of takeovers should recognize that such transactions take place in a national securities market.

The Commission agrees with this general proposition, which is consistent with Edgar v. MITE Corp., 11/ and the Commission's amicus briefs in MITE and Sharon Steel v. Whaland. 12/ However, the Commission's agreement should not be construed to justify a wholesale preemption of state corporate law. No specific action is required on this recommendation.

5. Cash and securities tender offers should be placed on an equal regulatory footing so that bidders, the market and shareholders, and not regulation, decide between the two.

The Commission supports the general proposition that regulatory disincentives to exchange offers should be minimized to the extent consistent with investor protection. Implementation of this recommendation and recommendations 11 and 12 will be the final major steps in the integration of the Securities Act and the Exchange Act

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11/ 457 U.S. 624 (1982).

12/ [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,528 (N.H., Sept. 30, 1983).

disclosure requirements. It will require an amendment to rules and administrative policies under the Securities Act.

6. Regulation of takeovers should not unduly restrict innovations in takeover techniques. These techniques should be able to evolve in relationship to changes in the market and the economy.

   The Commission agrees with this general proposition. It requires no specific action.

7. Even though regulation may restrict innovations in takeover techniques, it is desirable to have sufficient regulation to insure the integrity of the markets and to protect shareholders and market participants against fraud, non-disclosure of material information and the creation of situations in which a significant number of reasonably diligent small shareholders may be at a disadvantage to market professionals.

   The Commission agrees with this general proposition. It requires no specific action.

8. The evolution of the market and innovation in takeover techniques may from time to time produce abuses. The regulatory framework should be flexible enough to allow

the Commission to deal with such abuses as soon as they appear.

The Commission agrees with this general proposition. It requires no specific action.

9. a. State Takeover Law. State regulation of takeovers should be confined to local companies.

The Commission agrees with this general proposition, which is consistent with MITE and the Commission's amicus program. It requires no specific action.

b. State Corporation Law. Except to the extent necessary to eliminate abuses or interference with the intended functioning of federal takeover regulation, federal takeover regulation should not preempt or override state corporation law. Essentially the business judgment rule should continue to govern most such activity.

The Commission agrees with the Advisory Committee's recognition of the general preeminence of state corporate law with respect to the internal affairs of a corporation. However, in the application of the business judgment rule in a change of control context, the Commission believes

that shareholders would be better served if the courts gave greater recognition to potential conflicts of interest between management and shareholders. No specific action is required on this recommendation.

c. State Regulation of Public Interest Businesses. Federal takeover regulation should not preempt substantive state regulation of banks, utilities, insurance companies and similar businesses, where the change of control provisions of such state regulation are justified in relation to the overall objectives of the industry being regulated, do not conflict with procedural provisions of federal takeover regulation and relate to a significant portion of the issuer's business.

The Commission agrees with this general proposition. It requires no specific action.

d. Federal Regulation. Federal takeover regulation should not override the regulation of particular industries such as banks, broadcast licensees, railroads, ship operators, nuclear licensees, etc.

The Commission agrees with this general proposition. It requires no specific action.

e. Relationships with Other Federal Laws. Federal takeover regulation should not be used to achieve antitrust, labor, tax, use of credit and similar objectives. Those objectives should be achieved by separate legislation or regulation.

The Commission agrees with this general proposition. It requires no specific action.

III. Regulation of Acquirors of Corporate Control

10. Any regulation of one or more change of control transactions by either the Congress or the Commission should address the effects of such regulation in the context of all control acquisition techniques.

The Commission agrees with this general proposition. It requires no specific action.

11. The concept of integration of disclosure under the Securities Act of 1933 and the Securities Exchange Act of 1934, previously effected by the Commission in securities offerings for cash, should be extended to exchange offers.

The Commission agrees with this recommendation. It will require an amendment to rules and administrative policies under the Securities Act and the Exchange Act.

12. Bidders should be permitted to commence their bids upon filing of a registration statement and receive tenders prior to the effective date of the registration statement. Prior to effectiveness, all tendered shares would be withdrawable. Effectiveness of the registration statement would be a condition to the exchange offer. If the final prospectus were materially different from the preliminary prospectus, the bidder would be required to maintain, by extension, a 10-day period between mailing of the amended prospectus and expiration, withdrawal and proration dates. This period would assure adequate dissemination of information to shareholders and the opportunity to react prior to incurring any irrevocable duties.

    The Commission agrees with this recommendation generally, reserving judgment on specific means of effecting the proposal. It will require an amendment to rules and administrative policies under the Securities Act.

13. No person may acquire directly or indirectly beneficial ownership of more than 5% of an outstanding class of equity securities unless such person has filed a Schedule 13D and that schedule has been on file with the Commission for at least 48 hours. Such person may rely on the latest Exchange Act report filed by the target company

that reports the number of shares outstanding. The acquiror would have to report subsequent purchases promptly as provided by current law.

The Commission endorses closing the 10-day window period in Section 13(d). The Commission opposes a pre-acquisition filing requirement, because of its effect on the transferability of blocks of stock. The Commission proposes instead a requirement of immediate public announcement, next day filing of the Schedule 13D and/or a standstill until filing. The Commission's proposal will require an amendment to the Exchange Act.

14. No person may acquire voting securities of an issuer, if, immediately following such acquisition, such person would own more than 20% of the voting power of the outstanding voting securities of that issuer unless such purchase were made (i) from the issuer, or (ii) pursuant to a tender offer. The Commission should retain broad exemptive power with respect to this provision.

The Commission has serious reservations about this recommendation. Further study of the economic implications for the entire change of control area is required.

15. The Committee encourages the Commission to study means to strengthen the concept and definition of "group" or concerted activity.

The Commission has reviewed its rules and interpretations in light of this recommendation and concluded that additional action is not necessary at this time. The Commission will continue to monitor this area.

16. The minimum offering period for a tender offer for less than all the outstanding shares of a class of voting securities should be approximately two weeks longer than that prescribed for other tender offers.

The Commission is sensitive to the Committee's concerns regarding two-tier and partial offers but is not certain that the Committee's recommendation is the best way to address these concerns. This issue requires further study.

17. The minimum offering period for an initial bid should be 30 calendar days; for subsequent bids the minimum offering period should be 20 calendar days, provided that the subsequent bid shall not terminate before the 30th calendar day of the initial bid. In each case, the minimum offering period will be subject to increase, if the bid is a partial offer. The period during which

tendering shareholders will have proration and withdrawal rights should be the same length as the minimum offering period.

The Commission believes the tender offer process should not be permitted to become so complex that it is understood only by investment professionals. See Recommendation 32. The Committee's recommendations with respect to the timing of tender offers are too complex and may disadvantage non-professional shareholders. Shareholders would be better served by a system that simply provides for prorationing and withdrawal throughout the offering period, and a required minimum 20-business day offering period. The Commission endorses the Committee's proposal to eliminate the automatic extension of withdrawal rights upon commencement of a competing bid. The Commission intends to propose appropriate rule changes.

18. The minimum offering period and prorationing period should not terminate for five calendar days from the announcement of an increase in price or number of shares sought.

The Commission agrees that the offering period should be extended if there is an increase in price or the number of shares sought. Since prorationing and withdrawal rights are proposed to be required throughout an offer,

any extension of the offer will automatically extend such rights. The Commission reserves judgment on the length of the extension, pending public comment on a proposed rule change.

19. Where the bidder discloses projections or asset valuations to target company shareholders, it must include disclosure of the principal supporting assumptions provided to the bidder by the target.

The Commission does not endorse this recommendation at this time. In 1982, the Commission determined not to adopt a requirement of disclosure of assumptions when it issued its policy statement on projections 13/ and in 1979 when it adopted Rules 175 under the Securities Act and 3b-6 under the Exchange Act, 14/ which provide a safe harbor for such disclosures.

20. The Commission should review its disclosure rules and the current disclosure practices of tender offer participants to eliminate unnecessary or duplicative requirements, as well as inordinately complex or confusing disclosures. The Commission's rules should require a

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13/ See Release No. 33-6383 (March 3, 1982).

14/ See Release No. 33-6084 (June 25, 1979).

clear and concise statement of the price, terms and key conditions of the offer. In addition, the Commission should amend its rules to permit inclusion of the key conditions in a summary advertisement used to commence an offer.

The Commission agrees with this recommendation, and intends to propose appropriate rule changes.

21. The Commission should continue its efforts to facilitate direct communications with shareholders whose shares are held in street name.

The Commission agrees with this recommendation. In order to facilitate communications with beneficial shareholders, the Commission has implemented a broker-dealer program and recommended legislation to implement a program for banks and other nominees.

22. The Commission should require under its proxy and tender offer rules that a target company make available to an acquiror, at the acquiror's expense, shareholder lists and clearinghouse security position listings within five calendar days of a bona fide request by an acquiror who has announced a proxy contest or tender offer. The

Commission should consider prescribing standard forms (written or electronic) for the delivery of such information.

The Commission agrees with this recommendation, and intends to propose appropriate rule changes.

23. Tender offer reply forms should be standardized to the extent possible to facilitate handling by brokerage firms, banks and depositaries.

The Commission agrees with this recommendation, and will assist private sector initiatives in this area.

24. Except to the extent there already exists such a requirement in a particular context, the price paid by an acquiror unaffiliated with the target company should not be required to be "fair" nor should federal law provide for state law-type appraisal rights.

The Commission agrees with this endorsement of current law. No action is required.

25. All shareholders whose shares are purchased in a tender offer should be entitled to the highest per share price paid in the offer.

The Commission agrees with this endorsement of current federal securities regulation. No action is required.

26. Current prohibitions of the purchase by a bidder of target company shares other than under the offer should be continued.

The Commission agrees with this endorsement of current federal securities regulation. No action is required.

27. All time periods should be defined in terms of calendar days.

The Commission believes that all time periods should continue to be defined in terms of business days. No action is required.

28. "Commencement" of a tender offer should continue to be determined by present rules, and time periods should continue to run from that date.

The Commission agrees with this endorsement of current federal securities regulation. No action is required.

29. Offering documents that are required to be mailed should be mailed within seven calendar days of commencement by announcement.

The Commission agrees with this recommendation, and intends to propose appropriate rule changes.

30. Voluntary extensions may be made by the offeror with any type of offer at any time before the commencement of the first trading day after the expiration date of the offer.

The Commission agrees with this endorsement of current federal securities regulation. No action is required.

31. Approval by shareholders of a bidder with respect to an acquisition should continue to be an internal matter between shareholders and management, subject only to applicable state law.

The Commission agrees with this endorsement of current law. No action is required.

32. The takeover process should not be permitted to become so complex that it is understood only by investment professionals.

The Commission agrees with this general proposition. No action is required.

IV. Regulation of Opposition to Acquisitions of Control

33. The Committee supports a system of state corporation laws and the business judgment rule. No reform should undermine that system. Broadly speaking, the Committee believes that the business judgment rule should be the principal governor of decisions made by corporate management including decisions that may alter the likelihood of a takeover.

The Commission agrees with this general proposition, qualified by its concerns regarding the application of the business judgment rule in change of control situations. See recommendation 9(b).

34. State laws and regulations, regardless of their form, that restrict the ability of a company to make a tender offer should not be permitted because they constitute an undue burden on interstate commerce. Included in this category should be statutes that prohibit completion of a tender offer without target company shareholder approval and broad policy legislation written so as to impair the ability to transfer corporate control in a manner and time frame consistent with the federal tender offer process. An exception to this basic prohibition may be appropriate where a significant portion of the target company is in a regulated industry and where special change of control provisions are vital to the achievement of ends for which the industry is regulated. Where such change of control provisions cannot be justified in relation to the overall objectives of the industry regulations or where only a small portion of the target company is in the regulated industry, there should not ean automatic impediment to the completion of a tender offer. Rather, the tender offer

should be completed with the regulated business placed in trust during any post-acquisition approval period. Further, no such regulation should interfere with the procedural provisions under the Williams Act.

The Commission agrees with this general proposition, and intends to continue to implement this policy through its amicus program, which has been effective to date.

35. Congress and the Commission should adopt appropriate legislation and/or regulations to prohibit the use of charter and by-law provisions that erect high barriers to change of control and thus operate against the interests of shareholders and the national marketplace.

The Commission shares the serious concerns of the Advisory Committee with respect to the effects of these devices but is not prepared at this time to concur in such a broad intrusion into state corporate law.

36. To the extent not prohibited or otherwise restricted, companies should be permitted to adopt provisions requiring supermajority approval for change of control transactions only where the ability to achieve such a level of support is demonstrable.

a. Any company seeking approval of a charter or by-law provision that requires, or could under certain circumstances require, the affirmative vote of more than the minimum specified by state law should be required to obtain that same level of approval in passing the provision initially. Ratification should be required every three years.

b. Where a charter or by-law provision provides a formula for the required level of approval, which level cannot be determined until the circumstances of the merger are known, the formula shall be limited by law so as to require a vote no higher than the percentage of votes actually ratifying the charter or by-law provision. Ratification should be required every three years.

c. For a nationally traded company that has adopted a supermajority provision prior to the date of enactment of this recommendation, and for a local company with a supermajority provision which becomes nationally traded at a later date, shareholders must ratify the supermajority provision within three years after such date, and continue to ratify such provision every three years thereafter.

The Commission agrees with the Advisory Committee that implementation of super majority voting requirements should require comparable votes for adoption. As noted with respect to Recommendation 35, however, the Commission is not prepared at this time to concur in such a broad intrusion into state corporate law. The Commission does not agree that such provisions should be subject to re-ratification after adoption. Therefore, the Commission does not plan to take actions to implement 36(a), 36(b), or 36(c).

37. The Commission should designate certain change of control related policies of corporations as "advisory vote matters" for review at each annual stockholders' meeting for the election of directors and for disclosure in the proxy statement.

a. Matters Covered. Advisory vote matters should include:

i. Supermajority provisions. To the extent not prohibited or otherwise restricted, charter provisions requiring more than the statutorily imposed minimum vote requirement to accomplish a merger, including provisions requiring super-majority approval under special conditions (e.g., "fair value" and "majority of the disinterested shareholders" provisions);

ii. Disenfranchisement. Charter provisions (other than cumulative voting and class voting) that abandon the one-share, one-vote rule based on the concentration of ownership within a class (e.g., formulas diluting voting strength of 10% shareholders, and "majority of the disinterested shareholders" approval requirements);

iii. Standstill agreements. Current agreements with remaining lives longer than one year that restrict or prohibit purchases or sales of the company's stock by a party to the agreement; and

iv. Change of control compensation. Arrangements that provide change of control related compensation to company managers or employees.

b. Proxy Statement Disclosure. Companies should be required to disclose all advisory vote matters in a "Change of Control" section of the proxy statement.

c. Vote. Shareholders should be requested to vote on an advisory basis as to whether they are or continue to be in favor of the company's policy with respect to the advisory vote matters disclosed in the proxy statement. The board would not be bound by the

results of the advisory vote but could, in its own judgment, decide whether company policy should be changed on the advisory vote matters. The outcome of an advisory vote would have no legal effect on an existing agreement.

The Commission supports 37(b) and will propose for comment the concept of annual disclosure of certain change of control related policies. The Commission believes that the concept of advisory voting is problematic, however, and does not at this time support that element of the recommendation. Advisory votes have, by definition, no binding effect on directors. Such votes would subject corporations to considerable time and expense. The legal effect of advisory votes is unclear and could only be determined through costly litigation. Moreover, such a requirement could interfere fundamentally with traditional principles of corporate governance and fiduciary obligations of management applicable under state law. Because of the costs of advisory votes and the uncertain benefits, the Commission, while commending the Advisory Committee's originality in formulating the concept, does not endorse it.

38. a. Change of Control Compensation During a Tender Offer. The board of directors shall not adopt contracts or other arrangements with change of control compensation once a tender offer for the company has commenced.

b. Change of Control Compensation Prior to a Tender Offer.

i. Disclosure. The issuer should disclose the terms and parties to contracts or other arrangements that provide for change of control compensation in the Change of Control section of the annual proxy statement.

ii. Advisory Vote. At each annual meeting, shareholders should be requested to vote, on an advisory basis, as to whether the company should continue to provide change of control compensation to its management and employees. The board would not be obligated by the results of the vote to take any specific steps, and the outcome of the vote would have no legal effect on any existing employment agreement.

The Commission shares the Committee's concerns with the adoption of change of control compensation in the face of a takeover and concurs in the Committee's judgment that such activities may so undermine the public's confidence in the integrity of the takeover process as to require a federal response. The Commission takes no position on whether this is best done through tax legislation or other federal regulation, but would be happy to assist in the preparation of such legislation.

The Commission would suggest distinguishing between arrangements entered into after a takeover is threatened and those adopted in the ordinary course of business. This avoids the substantial problems of separating "golden parachutes" from ordinary employment contracts. As noted with Recommendation 37, the Commission does not favor advisory votes at this time. The Commission does agree that, as is currently required, issuers should disclose change of control related compensation, regardless of the timing of its adoption.

39. a. In general, target company self-tenders should not be prohibited during the course of a tender offer by another bidder for the target company.

The Commission believes defensive issuer tender offers should be prohibited, and intends to propose appropriate legislation.

b. Once a third party tender offer has commenced, the target company should not be permitted to initiate a self-tender with a proration date earlier than that of any tender offer commenced prior to the self-tender.

The Commission agrees with this recommendation, and intends to implement it by appropriate rule changes, pending legislation on 39(a).

40. There should be no general prohibition of the counter tender offer as a defense. The employment of the counter tender offer should be prohibited, however, where a bidder has made a cash tender offer for 100% of a target company.

The Commission has serious concerns about the use of counter tender offers as defensive tactics. Management should bear the burden of proving that a counter tender offer is not motivated by management's self-interest and reflects a reasonable business judgment. No specific action is planned by the Commission.

41. Contracts for the sale of stock or assets to preferred acquirors should continue to be tested against the business judgment rule. During a tender offer, however, the issuance of stock representing more than 15% of the fully diluted shares that would be outstanding after issuance should be subject to shareholder approval.

The Commission supports the concept of requiring shareholder approval for the issuance of any securities representing more than 5% (not 15% as proposed by the Committee) of the class to be outstanding after issuance during a tender offer or proxy contest. Included within this concept would be options, warrants, convertible and other

securities. The Commission supports the general proposition that state corporate law, subject to revised application of the business judgment rule in takeovers, should govern disposition of assets during a tender offer. The Commission intends to propose appropriate legislation.

42. The sale of significant assets, even when undertaken during the course of a tender offer, should continue to be tested against the business judgment rule.

The Commission supports this general proposition, subject to revised application of the business judgment rule.

43. Repurchase of a company's shares at a premium to market from a particular holder or group that has held such shares for less than two years should require shareholder approval. This rule would not apply to offers made to all holders of a class of securities.

The Commission agrees with this recommendation, and intends to propose appropriate legislation.

V. Regulation of Market Participants

44. The Commission should continue the current prohibition on short tendering set forth in Rule 10b-4. To ensure

the effectiveness of that provision, the Commission also specifically should prohibit hedged tendering. The Commission agrees with this recommendation. On March 29, 1984, the Commission will consider a rule proposal to that effect.

45. In furtherance of the policy goals of Rule 10b-4, the Commission generally should require in a partial offer that all shares tendered pursuant to a guarantee be physically delivered, rather than permitting delivery only of the certificates for those shares to be actually purchased by the bidder.

The Commission agrees with this recommendation, and intends to propose appropriate rule changes.

46. Rule 10b-4 should be amended to include a specific prohibition of multiple tendering.

The Commission agrees with this recommendation, and, on March 29, 1984, will also consider a staff recommendation to adopt proposed amendments to Rule 10b-4 prohibiting multiple tendering by appropriate rule changes.

47. The Commission should revise its interpretation of Rule 10b-4 so that for the purposes of determining whether a person has a "net long position" in a security

subject to the tender offer, call options on such security which a person has sold and which a person should know are highly likely to be exercised prior to expiration of the offer shall be deemed to constitute sales of the security underlying such options and therefore netted against such person's position in that security.

The Commission believes that the proposed interpretation is too subjective, thus making it difficult to administer and enforce. Therefore, the Commission does not endorse this recommendation, but intends to study the problem further.

48. Without commenting on the technical aspects of the proposal, the Committee recommends adoption of the Commission's proposed Rule 17Ad-14 under the Exchange Act.

The Commission has adopted Rule 17Ad-14, which requires bidders' tender agents to establish during tender offers an account with registered securities depositories to permit financial institutions participating in such depository systems to use the services of the depository to tender shares if desired.

VI. Interrelationships of Various Regulatory Schemes

49. Federal securities regulation of acquisition of corporate control should not impede or otherwise handicap the

necessary and appropriate workings of federal antitrust regulations designed to review transactions for antitrust implications prior to their consummation.

The Commission agrees with this general proposition. No specific action by the Commission is required.

50. Premerger notification waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act should be modified so as to take account of the required minimum offering period prescribed under the Williams Act and to avoid, to the extent practicable, delay in completion of a tender offer due to antitrust review.

The Commission agrees with this recommendation and intends to consult with the Federal Trade Commission (which administers Hart-Scott-Rodino), with a view to implementing this recommendation.

V. Conclusion

As discussed above, the Commission intends to submit legislative proposals to implement its responses to five of the Advisory Committee's recommendations 15/ and to take rulemaking actions to implement fourteen. 16/ The Commission would also be pleased to assist the Subcommittee in the preparation of legislation concerning golden parachutes.

15/ Recommendations 13, 21, 39(a), 41, 43.

16/ Recommendations 5, 11, 12, 17, 18, 20, 22, 29, 37(b), 39(b), 44, 45, 46, 48.

- EXHIBIT A

MEMBERS OF THE SECURITIES AND EXCHANGE COMMISSION
ADVISORY COMMITTEE ON TENDER OFFERS

Dean LeBaron, Chairman
President
Batterymarch Financial Management

Jeffrey B. Bartell, Esq.
Quarles & Brady
(former state securities commissioner)

Michael D. Dingman
President
The Signal Companies, Inc.

Frank H. Easterbrook
Professor of Law
The University of Chicago Law School

Joseph H. Flom, Esq.
Skadden, Arps, Slate, Meagher & Flom

Honorable Arthur J. Goldberg
(former Supreme Court Justice)

Robert F. Greenhill
Managing Director
Morgan Stanley & Co., Inc.

Ray J. Groves
Chairman and Chief Executive
Ernst & Whinney

Alan R. Gruber
Chairman & Chief Executive Officer
Orion Capital Corporation

Edward L. Hennessy, Jr.
Chairman of the Board
Allied Corporation

Gregg A. Jarrell, Ph.D.
Senior Economist
Lexecon Inc.

Robert P. Jensen
Chairman & Chief Executive Officer
E.F. Hutton LBO Inc.

Martin Lipton, Esq.
Wachtell, Lipton, Rosen & Katz

Robert E. Rubin
Partner
Goldman, Sachs & Co.

Irwin Schneiderman, Esq.
Cahill Gordon & Reindel

John W. Spurdle, Jr.
Senior Vice President
Morgan Guaranty Trust Company

Jeff C. Tarr
Managing Partner
Junction Partners

Bruce Wasserstein
Managing Director
The First Boston Corporation

EXHIBIT B

SEC Advisory Committee on Tender Offers
Agenda of Issues

Objectives: To review techniques for the acquisition of control of public companies ("takeovers") and the laws applicable thereto in terms of the best interests of all shareholders (i.e., shareholders of all corporations, whether potential acquirors, target companies or bystanders) and to propose specific legislative and regulatory improvements for the benefit of all shareholders.

I. Definition of Activities to be Reviewed.

The Committee has determined that, given the interrelationship of the various techniques to acquire control and the consequences of regulating one method of acquisition without taking into account the effect of such regulation on the relative advantages and disadvantages of other acquisition methods, it is necessary to consider the whole spectrum of acquisition techniques. The Committee recognizes, however, that given the anticipated date of its report to the Commission, it may not address in detail the full range of regulations, state and federal, applicable to proxy solicitations and mergers, but rather may focus on those issues that are common to such transactions and acquisitions of control through purchases of equity from investors.

II. Economics of Takeovers and their Regulation.

A. What is the economic effect of takeovers on:

1. acquirors and their shareholders - for example, what happens to an acquiror's financial condition, results of operations and stock price following an acquisition?

2. target companies and their shareholders - for example,

a. do takeovers provide a useful means of providing better management; and

b. does the prospect of takeover cause management to emphasize short-term results at the expense of long-term growth?

B. What is the relative effect of the following factors on the size and number of takeovers:

1. credit availability and policies;

2. tax policies;

3. antitrust policies;

4. market conditions;

5. general economic conditions;

6. accounting requirements (e.g., pooling, purchase, consolidation and equity accounting requirements);

7. laws applicable to change in control of regulated industries;

8. state takeover laws;

9. federal securities laws;

   a. 1933 Act (required registration of exchange offers)

   b. Williams Act

   c. other

10. state corporate law (e.g., fiduciary obligations); and

11. other?

C. What are the anticipated economic effects on acquirors, target companies, and the number and size of takeovers of adopting British type regulations that restrict or prohibit the ability of acquirors to:

   1. use two-tier pricing;

   2. engage in partial offers; and/or

   3. engage in open market accumulation programs at some defined level?

D. What is the economic effect on acquirors, target companies, their shareholders, and the number and size of takeovers of a regulatory environment that permits or encourages "auctions" of a target company?

E. What is the impact upon shareholders of the credit used to finance takeovers? Should the extension of credit for takeovers be regulated for the benefit of all shareholders?

III. Basic Objectives of the Federal Securities Laws Applicable to Takeovers.

The following issues are to be considered as an integral part of the Committee's consideration of the issues arising under captions IV, V, VI and VII.

Who should be protected under federal securities laws, what should the objectives of such regulation be and what premises should govern the balancing of these objectives?

A. Protection of shareholders (e.g., disclosure, proration, equality of treatment, substantive fairness).

B. Preservation of flexibility of business judgment for both the acquiror and target company.

C. Auctions of target companies.

D. Unfettered transfers of control.

E. Market liquidity and depth, efficiency in pricing. (Should takeovers be considered another dimension of market liquidity and thereby promoted under a mandate to extend market depth with full disclosure, promptness and reasonable cost?)

F. Ability of management to find alternative to takeover partners.

G. Neutrality (i.e. that the law have neither as its objective or effect, taking into account other regulatory objectives, the deterrence or promotion of takeovers).

IV. Regulation of Acquirors of Control.

A. To what extent can the procedures specified by law be made more uniform so that the current distinction between cash transactions and those using securities may be minimized? To what extent can the concept of integration of the 1933 and 1934 Acts be applied in the takeover area (where shareholders are compelled to make an investment decision) to streamline the procedures and disclosure required in connection with exchange offers and mergers?

B. Disclosure.

The primary purposes of the Williams Act are to assure that target company shareholders have the time and information to make informed investment decisions.

1. Are these purposes achieved by the current regulatory system?

   a. Is the current required disclosure meaningful and of use to most shareholders?

   b. Can some disclosure be eliminated or streamlined without lessening its effectiveness?

2. Should time and information continue to be the primary objectives of the law? Do such requirements serve the best interest of all shareholders?

3. What changes should be made in current disclosure requirements if disclosure continues to be a primary objective? For example:

   a. Should pro forma information be required in partial or proposed multiple step transactions?

   b. Should the accounting requirments with respect to purchase and pooling, consolidation and equity reporting be revised?

   c. Should tax disclosure be expanded and opinions of counsel on tax matters be required?

   d. Should projections of the target company given to the acquiror be required to be disclosed in its disclosure materials?

   e. Should tender offer materials be reviewed by the Commission prior to use as are proxy soliciting materials and registration statements used in connection with exchange offers and mergers?

4. Do acquirors and target companies have sufficient access to shareholders in an efficient, timely manner?

5. Do technological developments need to be taken into account in defining timing and disclosure requirements?

6. Do the current requirements under section 13(d) of the 1934 Act need revision? Is the disclosure required in the Schedule 13D useful to shareholders? Should acquirors be permitted to continue to purchase securities before the Schedule 13D is filed after the 5% threshold is reached? Should the criteria for reporting obligations be expanded to include any purchase that is part of an intended acquisition of control.

C. Terms of the Acquiror's Offer.

What substantive regulation should there be of the terms of the offer?

1. Price.

   a. Should it be required to be fair and if so by whose determination?

   b. Should all shareholders accepting the offer be entitled to the highest price paid in the offer?

   c. Should Dutch Auctions be permitted or encouraged?

   d. Should there be a limitation on, or prohibition of, two-tier pricing?

2. Limited Offers.

   a. Should partial tender offers be permitted?

   b. If partial offers are permitted, should shares be required to be accepted pro rata?

   c. Should there be a limitation on open market accumulation programs?

3. Minimum Offering Period.

   Should there be a minimum offering or solicitation period? If so, for what period?

4. Withdrawal Rights.

   Should withdrawal rights be required? If so, on what basis?

5. Should states law rights of appraisal be incorporated in federal law?

D. Approval of Acquiror's Shareholders.

   Should the acquiror have to obtain the prior approval of its shareholders of proposed major acquisitions and attendant financings?

V. Regulation of Opposition to Acquisition of Control.

A. Should state corporate law fiduciary obligations applicable to the board of directors be the principal means by which its activities are regulated? If so, should the "business judgment" rule continue to be the principal applicable standard?

B. If the business judgment rule is the appropriate standard against which to measure the board's actions, should there be different requirements (i.e. restrictions, requirements of shareholder approval or prohibition) with respect to one or more of the following actions:

1. Pac-man defense;

2. sales of "crown jewels";

3. target tender offers for their own shares;

4. use of employee benefit plans to defeat or deter tender offers;

5. "golden parachutes" and "silver wheelchairs" (i.e. employment and severance provisions that take effect upon a change in control);

6. lock-ups; leg-ups (e.g., sales of blocks of shares or options on shares to frustrate takeovers);

7. "shark repellents" (charter and by-law amendments to discourage takeover attempts);

8. "scorched earth" policies;

9. litigation; and

10. other defensive maneuvers?

C. Should the repurchase of shares by an issuer at a premium be proscribed?

VI. Regulation of Market Participants.

A. Is there a need to limit or prohibit short tendering, hedged tendering, double tendering?

1. What is the impact on the market and on the tender offer process of such practices?

2. Do such practices inordinately disadvantage the non-professional investor? If so, are there benefits to such investors that outweigh such disadvantages?

3. Is there a need to regulate substantively the tender guarantee mechanism?

B. Options.

Do problems exist in the tender offer process as the result of or because of the options markets? E.g., can and should there be a limitation on or other regulation of uncovered call writing during tender offers?

C. Clearing Systems.

Should regulations be adopted to require the use of depository book entry systems and/or require clearing corporations to maintain continuous netting programs during tender offers and to adopt uniform closeout and liability notice programs?

D. Risk Arbitrage.

Is there a need for substantive regulation of the activities of risk arbitrageurs?

VII. Interrelationship of Various Regulatory Schemes.

A. Should the Committee consider substantive issues with respect to tax, banking, antitrust, ERISA, etc. or limit itself to

considering whether in general the various regulatory schemes eventually should or could be coordinated procedurally and/or substantively?

B. What is the proper relationship of federal and state securities and corporate laws and laws applicable to regulated industries?

1. Should there be state regulation of third party acquisitions of securities from shareholders (e.g., new Ohio statute)?

2. At present acquirors' activities are, as a practical matter, principally restricted by the federal securities laws, while the target's responses are, as a practical matter, principally subject to state regulation. Is this appropriate? If not, what should be done about it? What is the appropriate relationship between the federal securities laws and state laws applicable to changes of control of regulated industries?

VIII. Additional Issues.

A. See the additional issues raised by 12 members of the Senate Banking Committee in the attached letter.

B. What Commission enforcement presence is possible or appropriate, given the timing of control acquisitions? Are changes needed in the applicable laws to permit an effective enforcement presence?

C. To what extent do continuing changes in the law applicable to takeovers create inordinate difficulties for participants and shareholders?

EXHIBIT C

July 8, 1983

John S.R. Shad
Chairman
Securities and Exchange Commission
Washington, D.C. 20549

Dear Chairman Shad:

We are enclosing the final report of the Commission's Advisory Committee on Tender Offers which was established on February 25, 1983. The eighteen members of this Advisory Committee met six times in full session. Countless meetings of six sub-committees were held to prepare recommendations to the full body. We had the benefit of extensive experience of our individual members in completing our assignment within our original time frame.

The summary report emphasizes that we concentrated our work and recommendations on shareholders' interests. We are cognizant, however, of interest in takeovers on broader governmental, societal, jurisdictional planes and have touched on these issues in our work. We specifically address some questions put to us through the Commission that express Congressional concerns.

Our recommendations are detailed, technical and comprehensive. We expect the Commission to put them in place by rule making or by recommending legislation, or regulation, as may be required, as they stand. They are designed to be an integral and cohesive body.

I would like to point out the fundamental bases upon which our recommendations rest. There are other technical solutions which are consistent with our fundamental policy objectives. Throughout the meetings of the Committee we encouraged diversity of opinion and dissent. One of our functions was to bring out a number of ideas which might otherwise have become buried in a carefully negotiated majority view. We hope the Commission will draw upon this diversity of views in reaching your ultimate decisions.

The Committee respects the free market forces in the operation of the U.S. securities markets. Academic evidence is widespread that the takeover process is at least not demonstrably harmful to shareholders and some evidence points to its systematic benefits. We would be reluctant to restrict a process which seems to work reasonably well with the possibility that we might incur some unintended harm. The Committee is humble in its ability to anticipate all of the

takeover innovations that are likely to occur: good and bad. Our instincts led us to rely upon competitive markets as the ultimate regulator for the unforeseen specifics that may affect security holders. Our recommendations should promote private investment systems rather than hamper capital flows by heavy reliance upon rule making. We are attracted to solutions which are characterized by flexibility, simplicity and lower costs.

A theme running through our recommendations is to promote the disclosure of meaningful information to all investors. The tender offer process seems the best way available to us of insuring that terms, price and conditions are made available equally to all shareholders in a timely fashion. We suggest that purchases above 20% ownership be offered to all shareholders through the tender process.

We resist the temptation to bar substantial partial positions in companies. In most instances, we would expect that the acquisition of control would be accompanied by the purchase of all shares. There are circumstances in this country, as in international markets, where partial participation establishes business relationships which encourage cooperation and productive sharing of skills. We would not wish to alter these affiliations. We do, however, recommend that the partial positions receive somewhat less favored treatment than purchases which are contemplated to be for an entire company.

We are introducing an improvement in shareholder democracy in the form of advisory votes. We do believe that shareholders should have a mechanism to express their periodic will on charter provisions which may limit conditions under which their stock may be sold. Company directors, on the other hand, should not be bound to act against their business judgment in the shareholder interest. We do believe that the advisory vote concept will become a useful device in measuring shareholder sentiments.

We encourage procedures which will equate the offering of cash and securities. A number of purchases are accomplished initially for cash because Commission procedures are simplified for cash, and then are converted later into securities. Should cash and securities be administratively equated in the first instance, the latter potentially cumbersome and expensive step can be eliminated.

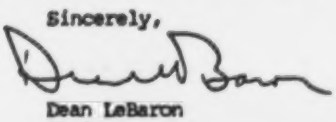
Throughout our discussions we have argued for simplicity in the procedures which may be required. This simplification may in some measure counteract the almost natural attraction to an elegance of rule making to guard against a number of perceived evils, especially those of recent anecdotal evidence.

Documentation by academic sources, business reports and the Commission staff were very helpful in our deliberations. We benefited from a review of takeover practices in other countries which included generous personal visits by United Kingdom and Canadian representatives.

The committee would have been unable to complete its work without the competence, diligence and hard work of the staff assigned to it. David Martin, Secretary to the Committee, did excellent work in keeping us administratively on track. Linda Quinn, Associate Director, diplomatically functioned in a continuing and important role.

Finally, we hope that the Commission and its staff will draw upon the Committee members for their advice and counsel in the future as you wish. Although we are disbanded with this report, our interest has not lessened and our willingness to serve remains keen.

Sincerely,



Dean LeBaron
Chairman
Securities and Exchange Commission
Advisory Committee on Tender Offers

EXHIBIT F

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

February 22, 1985

The Honorable Alfonse M. D'Amato
Chairman, Senate Securities Subcommittee
SH-520 Hart Senate Office Building
Washington, D.C. 20510

Dear Chairman D'Amato:

Thank you for your letter of November 16, 1984, requesting the Commission's views concerning the impact of two proposals on the takeover market, state corporation law, capital formation, and management entrenchment.

The following are my views, in which three of the other Commissioners concur. The fifth Commissioner takes exception to the statements made with respect to partial acquisitions, particularly hostile partial tender offers.

The Commission would oppose Congressional adoption of either proposal. Both would place serious limitations on acquisitions of equity in public companies. These limitations would not only impede market forces and further entrench management, but also inhibit other sound economic justifications for partial acquisitions. Moreover, the Commission is not prepared to endorse federal preemption of state corporate law for such purposes.

The first proposal would limit holders of 5% to 90% of an issuer's common stock to 5% of the vote for three years and would require management to submit to its shareholders, and take no action to frustrate, any unconditional cash offer for all the stock at twice the current market price.

To require a holder of less than 90% of the stock of a company to give up voting for all but 5% of the shares for three years would inhibit, if not preclude partial acquisitions, whether friendly or unfriendly, and whether takeover or investment motivated. The investor would be deprived of important rights while at economic risk. Those who risk their funds should be entitled to the rights of ownership. The 5% voting power limitation also would seriously impair shareholders' ability to take legitimate issue with management through the proxy process.

The voting rights of corporate securities is a fundamental issue of state corporate law. The Commission does not support federal preemption of such rights for this purpose.

The proposed counter-balancing provision, that management could not oppose unconditional cash offers for all the shares at twice the market price, does not adequately offset the foregoing adverse consequences. Because of the variety of business, market, competitive, legal and other uncertainties and risks, there have been few, if any, unconditional 100% premium cash offers for all the shares of companies. In addition, the restriction on management actions would also involve a preemption of state corporate law that the Commission does not support for this purpose.

Finally, neither feature of this proposal requires federal legislation. Companies can implement them by submitting them to their shareholders for approval under the existing proxy rules.

The second proposal would require a person acquiring 20% of a company's common stock to make a tender offer for all the shares on identical terms and would extend the minimum offering period from the current 20 business days to 40 calendar days. The Commission opposed similar proposals by Senators Specter and Metzenbaum in testimony at the October 2, 1984 Senate Banking Committee hearings.

This proposal would also inhibit friendly and contested partial acquisitions, including equity investments of more than 20% and majority-owned subsidiaries. The consequences for the takeover market, capital formation and management entrenchment discussed above are equally applicable to this proposal.

Moreover, to require that any person acquiring over 20% of an issuer must offer to buy the entire company will tend to immunize large companies from takeovers. Studies indicate that the average target company subject to a partial tender offer has been three to five times larger than the average target company in an any-and-all offer.

Also, there are many sound and practical justifications of partial acquisitions. Such acquisitions:

(i) allow companies to invest in others, with less than 100% financial exposure;

(ii) facilitate technological exchanges and relationships;

(iii) permit proportional recognition of 20% or larger interests, under corporate equity accounting;

(iv) facilitate venture capital, foreign and other direct investments; and

(v) permit investors to become familiar with potential acquisitions, before deciding to increase their investment.

Some contend that two-tier and partial tender offers are coercive and that non-professional shareholders do not have adequate opportunity to participate in such offers. All friendly and contested tender offers, mergers and similar transactions are "coercive" to the extent that they afford shareholders the opportunity to accept or reject substantial premiums within a specified time period. Studies show that in 1980-83, the average premium for any-and-all offers was 63%, for two-tier offers a 55% blended premium (64% in the first tier and 47% in the second tier), and 31% for partial offers.

Further, there is little evidence that individual shareholders have had difficulty in participating in offers for less than all the shares. A survey of the successful partial offers for more than 50% of outstanding shares during fiscal 1984 shows that an average of approximately 87% of the shares were tendered prior to the expiration of the offer.

In response to Senator Metzenbaum's proposal to extend the minimum offering period to 40 calendar days, the Commission testified on October 2, 1984 that the current 20 business day (equivalent of 28 calendar day) offering period is adequate for shareholders to receive, consider and act on tender offers; that the longer period is not necessary for the protection of shareholders; and that the longer offering period would inhibit first bidders, but for whom there would be no competitive bids at higher prices.

The Commission opposed H.R. 5693, which would have extended the mimimum offering period to 40 calendar days. The House Energy and Commerce Committee Report (H. Rep. 98-1028) which accompanied the bill did not suggest that shareholders need more time to make informed investment decisions. It focused on the advantages to target company managements of the longer offering period; noted the potential for more competing bids; and acknowledged the consequent reduction in the number of tender offers.

If you desire any additional information, please call me or Linda C. Quinn (272-2000), my Executive Assistant.

Sincerely yours,

John S.R. Shad

STATEMENT OF JOHN S.R. SHAD
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

Tuesday, October 2, 1984

Chairman Garn and Members of the Committee:

I. Introduction

The Commission appreciates this opportunity to testify on four proposals to amend the federal securities laws. Since this hearing was called on short notice, the Commission will be pleased to provide supplemental responses to questions, if any, not fully addressed in this testimony.

The four proposals under consideration are innovative approaches to important issues, but the Commission does not support these amendments at this time for the reasons set forth below.

II. Background

By way of background, the Commission established a Tender Offer Advisory Committee on February 25, 1983. The Senate Banking Committee was supportive of the creation of the Advisory Committee, requested that its report be provided

by July 31, 1983 and raised a number of issues 1/ to which the Advisory Committee responded in its July 8, 1983 report. 2/

The Commission requested the Advisory Committee to review tender offer practices and regulations and propose specific regulatory and legislative improvements for the benefit of all shareholders (i.e. shareholders of all corporations, whether potential acquiror, target or bystander company).

The Advisory Committee's July 8, 1983 report was delivered to members of the Senate Banking Committee and the House Energy and Commerce Committee.

With the benefit of the Advisory Committee's report and the Commission's independent analysis, the Commission submitted to Congress on May 21, 1984 legislative proposals which would make the following statutory changes:

(a) reduce the 10-day filing requirement under Section 13(d) of the Securities Exchange Act of 1934 (Exchange Act);

1/ See Exhibit A (letter of February 1, 1983 to Chairman Shad from members of Senate Committee on Banking, Housing and Urban Affairs).

2/ See attached July 8, 1983 letter from Dean LeBaron, Chairman, Advisory Committee on Tender Offers, to Securities and Exchange Commission Chairman John S.R. Shad, transmitting the Report of Recommendations of the Advisory Committee on Tender Offers (Exhibit B).

(b) prohibit "golden parachutes" and defensive issuance or reacquisition of securities by target companies during tender offers which meet specified criteria; and

(c) prohibit "greenmail" unless approved by a majority of shareholders or unless an equal offer is made to all shareholders. 3/

III. Proposals for Tender Offer Regulation

The Senate Banking Committee, by letter dated September 27, 1984, requested that the Commission address four amendments proposed during Senate floor debate on S. 2851, the Financial Services Competitive Equity Act. The four amendments are: (A) legislative extension of the minimum offering period from 20 business to 60 calendar days proposed by Senator Howard Metzenbaum; (B) changes in regulation of two-tier and partial tender offers, proposed by Senator Arlen Specter and Senator Howard Metzenbaum; (C) imposition of a requirement that directors individually be required to own or agree to purchase 1,000 shares of stock in the issuers on whose boards they serve proposed by

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3/ The Commission had previously transmitted to Congress, on April 23, 1984, a legislative proposal entitled "The Shareholder Communications Act of 1984." This proposal, which would authorize the Commission to regulate the proxy processing activities of banks, associations and other entities in the same fashion as the Commission currently regulates broker-dealers, emanates from the Advisory Committee report, as well as from the recommendations of the earlier Advisory Committee on Shareholder Communications.

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Senator John Chafee; and (D) creation of a federal cause of action to challenge corporate management decisions related to change of control transactions proposed by Senator John Chafee. The Commission's views on these four amendments are set forth below.

A. Minimum Offering Period Extension

Senator Metzenbaum's proposed amendment would require that tender offers be held open for at least a 60 calendar day period. This would approximately double the current 20 business day minimum offering period (approximately 28 calendar days), required by Rule 14e-1 (17 C.F.R. 240.14e-1).

In determining the appropriate length of the minimum offering period to be prescribed by Rule 14e-1, promulgated in December 1979, the Commission was guided by two basic goals: (a) to assure shareholders of target companies sufficient time to make and act upon informed investment decisions, and (b) to maintain the neutrality of the regulation between bidders and target companies to the extent consistent with the protection of shareholders as specified by Congress in adopting the Williams Act. 4/

This principle of neutrality was reaffirmed by Congress in 1976 when it adopted the Hart-Scott-Rodino Amendments ("HSR") to the Clayton Act. The committee report accompanying the

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4/ H.R. Rep. No. 1711, 90th Cong., 2nd Sess. 4 (1968).

amendments in discussing the abbreviated review period for HSR filings required in connection with cash tender offers noted that a basic principle underlying the Williams Act was to "maintain a neutral policy * * * [with respect to] tender offers, by avoiding lengthy delay that might discourage their chances for success." 5/

Following ten months deliberation, including analysis of approximately 100 written comments from law firms, corporations and others, the Commission adopted a 20 business day minimum offering period, after carefully considering and rejecting a 30 business day minimum period. The Commission concluded that a 20 business (28 calendar) day minimum offering period provides adequate opportunity for informed investment decisions and thus serves the purposes and policies of the Williams Act. 6/ Since adoption in December 1982 of Rule 14d-8 (17 C.F.R. 240.14d-8), shareholder complaints over the adequacy of the time have been negligible.

5/ H.R. Rep. No. 1373, 94th Cong., 2d Sess. 12 (1976).

6/ Release No. 33-6158 (November 29, 1979).

Prior to the adoption of Rule 14e-1, there was no specific minimum offering period under the Williams Act. As a practical matter, the seven day withdrawal period in Section 14(d)(5) of the Williams Act and the 10 day proration period in Section 14(d)(6) served to establish the federal minimum offering period for 100% and partial offers, respectively.

We would note that the report of the House Energy and Commerce Committee accompanying H.R. 5693, 7/ which would extend the minimum offering period to 40 calendar (29 business) days, does not suggest that shareholders need more time to make an informed investment decision. The House committee report speaks to the advantages to target company managements of the longer offering period and notes that it would provide more time for competing bids, and that various witnesses testified that extension of the minimum offering period would result in fewer tender offers.

The Commission's Advisory Committee on Tender Offers considered whether an extension of the minimum offering period was warranted. After careful consideration, the Advisory Committee concluded that extension of the minimum offering period was not necessary for shareholder protection and that an extension would not be consistent with the neutrality of the Williams Act. The Advisory Committee recommended that the minimum offering period for first bids be 30 calendar days (approximately 21 business days), with a shorter period for subsequent bids, and a longer period

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7/ H.R. Rep. No. 1028, 98th Cong., 2nd Sess. (1984).

for partial tender offers. 8/ As the Commission testified before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Energy and Commerce Committee in March 1984, the Commission determined that adoption of the Advisory Committee's exact proposal would create an overly complex system, which might disadvantage non-professional shareholders. The Commission endorsed instead the 20 business day minimum offering period (28 calendar days) with prorationing and withdrawal rights throughout. 9/

At the present time, the weight of evidence is that the current offering period provides adequate time for shareholders to receive, consider and act on tender offer proposals. An extension may benefit some shareholders, but on balance it would increase the costs of the tender offer process unnecessarily, deter tender offers, and consequently undermine the basic principle of neutrality underlying the Williams Act.

Finally, the Commission believes that, in view of rapid developments in technology, the minimum offering period should be set by rule and not fixed by statute. Adjustments in the offering

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8/ The longer period was intended to be a disincentive to partial and two-tier offers.

9/ The Commission concurred in the Advisory Committee's recommendation to eliminate the automatic extension of withdrawal rights upon commencement of a competing bid. See Minutes of Commission open meeting on March 13, 1984.

period may prove necessary as means of communication with shareholders are improved. Such adjustments can be made more expeditiously if left to Commission rulemaking.

B. Regulation of Two-Tier and Partial Tender Offers

Senator Metzenbaum's proposed amendment provides that any person who makes a tender offer which would result in beneficial ownership of more than 20% of a class of a company's securities 10/ must make the same tender offer, request, or invitation to all shareholders. No exemptive authority is granted to the Commission, but an exception for issuer tender offers is included. This proposal simply requires that a tender offer be extended to all shareholders, if the bidder will own more than 20% of the class of stock. It does not require that the offer be made for all the shares. Thus, it would not address the issue of two-tier offers. Moreover, under the current law, the Commission already requires that any tender offer resulting in ownership of more than 5% of a class of stock must be made to all the holders on the same terms. 11/ The Commission believes therefore that this proposal is not necessary.

10/ The proposed amendment would apply to certain classes of equity securities, making it applicable during tender offers covered by Section 14(d) of the Exchange Act. This limitation is also contained in Senator Specter's bill.

11/ This applies to the same class of equity securities covered by Senators Metzenbaum's and Specter's proposed legislation.

S. 2448, introduced by Senator Specter, provides that any person who, after March 20, 1984, makes a tender offer which would result in the beneficial ownership of more than 20% of a class of a company's securities must make a cash offer for 100% of the outstanding shares of the class. 12/ An exception is provided for issuer tender offers, and the Commission is granted exemptive authority. S. 2448 would proscribe partial and two-tier offers but not additional share purchases in the open market or through negotiated transactions.

The Commission testified in March 1984 that federal regulation of partial tender offers and two-tier takeovers is a difficult and complex issue. It was the subject of substantial debate during the Advisory Committee's deliberations. Those who believed that partial and two-tier offers serve valid business purposes did not believe such offers require special federal regulation so long as there is an equal opportunity for all shareholders to participate in all phases of the bid. 13/

12/ This provision could affect the ability of companies to make investments in other companies that may be accounted for on an equity basis. Generally, such accounting triggers at the 20% level.

13/ In successful 1983-84 tenders for over 50% of the shares, 87% of the shares were tendered into the first step of two-tier offers.

They concluded that any additional regulation would adversely affect both shareholders and the markets. Others disagreed on the grounds that such bids are coercive. The Advisory Committee recommended that "the minimum offering period for a tender offer for less than all the outstanding shares of a class of voting securities should be approximately two weeks longer than that prescribed for other tender offers." The additional two weeks was intended to be a disincentive to partial and two-tier offers. The Advisory Committee's recommendation was based on a specific rejection of the argument that partial and two-tier bids should be prohibited.

The Commission is sensitive to the concerns which have been raised, but has not yet taken a position on two-tier and partial offers. It has solicited public comment on the issues and alternatives. (Release No. 34-21079 (June 21, 1984)). As discussed in Release No. 34-21079, the initial issue is whether partial and two-tier bids are harmful to target company shareholders.

The principal argument advanced by those who believe two-tier offers are harmful has been that they coerce shareholders to accept the initial offer, because if it is successful, they

will receive less in the second step. They apply the same logic to partial offers in which shareholders may receive less in subsequent offers or if they sell in the open market.

Those who argue against the need for restriction or prohibition of partial and two-tier offers contend that:

a) Partial offers have long been an accepted practice that serves valid business purposes, which include:
   - o allowing companies to invest in one or more industries with more limited financial exposure than 100% ownership;
   - o facilitating technology exchange relationships;
   - o permitting changes of control and reducing management entrenchment in large companies;
   - o facilitating private direct investment, such as venture capital;
   - o acknowledging common practices of foreign investors in the United States; and
   - o allowing acquirors to get to know a potential acquiree, before deciding to increase their investment.

b) To the extent that partial bids are restricted, concerns have been raised about immunizing large issuers from tender offers.

c) Two-tier offers cannot be regulated, without also regulating partial offers.

d) Two-tier offers provide substantial premiums to shareholders. Based on a study by the Commission's Office of Chief Economist, initial offers have been at a 64% average premium over the prior market price of the stock and the second step at a 47% average premium, a 55% average blended premium, as compared with 31% in partial offers (based on an average 46% premium in the tender offer and a 19% premium in the market following the offer) and a 63% average premium in all-or-any offers. While stocks generally decline to lower prices following partial tender offers, they have initially traded at a 19% average premium following the offer (unadjusted for market movements). 14/

e) Over the past three years, there has been a steady decline in the absolute and relative number of two-tier offers. In the fiscal year ended September 30, 1982, the 32 two-tier offers amounted to approximately 27% of all tender offers. In fiscal 1983, the 24 two-tier offers were 26% of all offers. In fiscal 1984, the 15 two-tier offers were 13% of all offers.

14/ See The Economics of Partial and Two-Tier Tender Offers, June 21, 1984, study by the Commission's Office of Chief Economist of 148 tender offers between 1981 and 1983 (included in Exhibit C).

f) Finally, rights of appraisal, class actions and other remedies against unfair transactions are available to shareholders under state and federal laws.

In addition to the Commission's economic analysis of tender offer premiums, the Commission has solicited public comment on several alternative approaches to two-tier offers, including:

a) The Advisory Committee's proposal to increase by two weeks the minimum offering period for such offers. A variation of this proposal would be to reduce the offering period required in a cash bid for all the shares.

b) A requirement that a bidder make a tender offer for all shares once a certain threshold of holdings is reached by the bidder. This is the S. 2448 approach. Proposals for triggering thresholds have ranged from as low as 10% to as high as 30%. Issues raised by this proposal are the effects on the costs of toe-hold acquisitions, the alienability of shares, and the economic consequences of so limiting the ability to make partial investments in public companies.

c) A proposal, derived from the British Takeover Code, that would require that partial offers to target company shareholders permit them to accept or reject the offer and also to vote for or against it in their letters of transmittal. The tender offer reply form thus would permit shareholders to exercise two choices in response to bids. First, shareholders may tender or not tender their shares. Second, they may vote for or against the offer. If they tender their shares and a majority of the shareholders vote against the offer, their shares will be returned and the bid will not be permitted to proceed. If they tender and a majority votes for it, their shares will be accepted even though they voted against it. Thus, in partial and two-tier offers, shareholders may tender while at the same time voting against them. This assures that if the holders of a majority of the shares approve the offer, dissenting shareholders will not have lost the opportunity to participate in the offer.

d) A proposal to limit two-tier offers, but permit partial offers, by requiring that all second step acquisitions of shares within a specified period of time be at least as high in price as the first step. The price of the partial offer would be the minimum the bidder could offer for additional shares. This alternative would

inhibit two-tier bids; however, as indicated above, shareholders have received significantly larger premiums in two-tier bids than in partial bids.

The Commission's solicitation of public comments included the tender offer study by its Office of Chief Economist cited above. This study covered 91 all-or-any, 32 two-tier and 25 partial tender offers in 1981-83. The data showed that the average premium for all-or-any tender offers was 63%. In two-tier offers, the average first-step premium was 64% and the average second-step premium was 47% (a blended premium of 55%). In partial offers, the average premium was 46% and the average market price following the offer (measured on the twentieth trading day after completion of the offer) was 19% for an average blended premium of 31% (unadjusted for market movements). Moreover, 72% of the two-tier offers had blended premiums above 40%, as compared with 68% of the all-or-any offers. 15/

Public comments in response to Release No. 34-21029 are still being received.

C. Share Ownership By Directors

Senator Chafee's proposed amendment, which is identical to his bill, S. 2797, proposes that the Exchange Act be amended to direct the Commission to require, by regulation,

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15/ The Release and Study are attached as Exhibit C.

that directors of publicly owned companies 16/ be required either to own at least 1,000 shares of stock in the issuers on whose boards they serve or to agree to "make perodic purchases of such shares using the total amount of that director's fees" from such issuer until 1,000 shares are purchased.

The Commission agrees that it is desirable for directors to own shares in their companies and believes most do. However, S. 2797 raises the following questions:

a) The qualifications of directors goes to the heart of corporate governance, an area widely accepted to be within the prerogative of state corporate law and the charter and by-law provisions of individual issuers. To begin to establish federal qualifications for directors of all public companies would be an extraordinary preemption of state corporate law.

b) Such a share ownership requirement could make it more difficult to recruit qualified directors. Even with the provision that the requirement may be met by the

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16/ S. 2797 applies to those companies whose equity securities are registered pursuant to Section 12 of the Exchange Act.

purchase of stock with directors' fees as they are paid, the requirement may discourage potential outside directors, particularly from academia, labor, consumer groups, minorities, and other constituencies. Those who would have to rely on the acquisition of stock through the application of fees may not be able to give their time in return for compensation which essentially takes the form of equity that must be held as long as they are directors. For example, a 1982 Commission study of 961 companies indicated that 77% paid directors annual compensation of less than $10,001. Assuming market prices of $10 to $50 per share, it would take at least one to five years for directors of these companies to satisfy a 1,000-share ownership requirement. They would receive no cash compensation for their time over such an extended period and would be required to pay taxes on their compensation, without receiving any cash to do so.

c) If directors of publicly owned companies who do not own shares were given such shares by the companies, all other directors could reasonably expect to receive similar treatment, which would dramatically increase the cost of directors' services to companies, and therefore their shareholders.

d) If issuers gave all directors 1,000 shares, plus sufficient cash to pay the resulting taxes, it would not only dramatically increase costs, it also would fail to achieve the intended effect of the requirement, since, unlike the shareholders, the directors would not have their own funds at risk.

e) In the case of penny stock companies, the 1,000-share requirement would be negligible.

D. Business Judgment Rule

Senator Chafee's proposed amendment is a provision of his bill (S. 2779) and also of S. 2777, introduced by Senator John Heinz. These bills would provide a federal cause of action for both the Commission and shareholders to challenge conduct by the board of directors of an issuer in connection with change of control transactions. The proposals would preempt the business judgment rule under state corporate law and would make all management actions in connection with changes of control subject to substantive federal regulation. S. 2779 and S. 2777 reflect concern with the "virtually unlimited discretion of management" to oppose takeovers through defensive maneuvers.

The Commission testified in March 1984 that it believes shareholders would be better served if the courts gave greater recognition to potential conflicts of interest between management and shareholders in change of control situations. However, the Commission has opposed proposals to define a federal standard for the conduct of the board of directors or to provide a federal cause of action for breaches of directors' fiduciary duties. Such proposals would be far-reaching preemptions of fundamental state corporate law.

Also, S. 2779 and S. 2777 are not limited to management responses to hostile takeovers. They would apply to all transactions "in contemplation of effecting, or of defending against, a change in control of such issuer." Thus, management's conduct in connection with major corporate actions that could affect control, such as mergers, liquidations, sales of securities, proxy solicitations and exchange offers, whether friendly or hostile, would be subject to substantive federal regulation. The need for such far-reaching preemption of state corporate law has not been demonstrated.

While there is a considerable body of case law that presumes the regularity of management conduct in change of control situations, there is evidence of an emerging judicial

sensitivity to conflicts of interest in changes of control situations. A recent example is the Second Circuit's decision in Norlin Corp. v. Rooney, Pace Inc., et al. 17/ In response to a perceived takeover threat, the board of directors of Norlin issued new common and voting preferred stock to a wholly-owned subsidiary and a newly created employee stock option plan, which was controlled by the directors. The district court granted a preliminary injunction barring the board from voting the stock in question. The court of appeals, in affirming the district court's decision, stated that a board member's obligation to a corporation under New York law has two prongs, a duty of care and a duty of loyalty. The court emphasized that the business judgment rule governs only situations in which the directors are not shown to have a self-interest in the transaction: "Once self-dealing or bad faith is demonstrated, the duty of loyalty supersedes the duty of care, and the burden shifts to the directors to 'prove that the transaction was fair and reasonable to the corporation.'" 18/

17/ [Current] Fed. Sec. L. Rep. (CCH) ¶91,564 (2d Cir. June 27, 1984).

18/ Norlin, ¶91,564 at p. 98,867, quoting Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980).

The court found that the defensive tactics of Norlin's board of directors created "a strong inference that the purpose was * * * to solidify management's control of the company. * * * Where * * * directors amass voting control of close to a majority of * * * shares in their own hands * * * it strains credulity to suggest that the retention of control * * * played no part in their plans." 19/ The court's willingness to look closely at the potential for conflicts of interest in takeover situations, and its conclusion that, once such self-interest is indicated, "the duty of loyalty requires the board to demonstrate that any actions it * * * take[s] are fair and reasonable," 20/ may indicate that the greater judicial sensitivity desired by the Commission is developing.

IV. Conclusion

The four proposals under consideration are innovative approaches to important issues, but the Commission does not support these amendments at this time for the reasons set forth above.

19/ Norlin, ¶91,564 at p. 98,867.

20/ Id. at p. 98,868.

EXHIBIT A

JAKE GARN, UTAH, CHAIRMAN
JOHN TOWER, TEXAS
WILLIAM PROXMIRE, WISCONSIN
ALAN CRANSTON, CALIFORNIA
DONALD W. RIEGLE, JR., MICHIGAN
PAUL S. SARBANES, MARYLAND
CHRISTOPHER J. DODD, CONNECTICUT
ALAN J. DIXON, ILLINOIS
JIM SASSER, TENNESSEE
FRANK R. LAUTENBERG, NEW JERSEY
E. SHARP GRAY, STAFF DIRECTOR
KENNETH A. MCLEAN, MINORITY STAFF DIRECTOR

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

February 1, 1983

The Honorable John S.R. Shad
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Shad:

We welcome the announcement that the Securities and Exchange Commission will shortly begin a full-scale study of the federal tender offer regulations, with an eye to proposing new legislation in Congress.

Commentators have suggested that the most feasible approach to current problems with tender offer law would be for Congress to revisit the program it began a decade ago, expanding the provisions of the Williams Act to deal with tender offer abuses, providing the judiciary with guidelines for determining the validity of challenges to bidder or management conduct during the course of an offer, and clarifying the respective rules of federal and state regulation.

The proliferation of contested take-overs over the past few years and the corresponding publicity has resulted in considerable Congressional interest in this subject. It would be most helpful to us if the Commission would address, among others, the following issues in its study:

What should be the role of the government in hostile take-overs?

What is a corporation's obligations to its shareholders, its employees, consumers, and the community in a take-over situation?

What abuses have occurred under current tender offer law?

Chairman Paul A. Volcker, of the Federal Reserve, has expressed concern "about take-overs distorting banking judgments or the credit markets." How might such distortions be prevented?

What should be the involvement of states in regulating corporate take-overs?

Should shareholders of a corporation be given the right to vote on proposed tender offers within a specific period of time of the offer, and should a shareholder majority be required to approve acquisitions and take-overs?

Are "golden parachute" provisions guaranteeing executives salaries and other compensation after any change of control of a company in the best interests of shareholders of that company? Should federal securities law require shareholder approval of golden parachutes or that their provisions be spelled out in detail in companies' proxy materials?

Should interest on money borrowed specifically to buy the common stock of another corporation in a take-over situation be tax deductible?

Should retained earnings used to acquire other companies be subject to a minimum merger tax?

Should additional time for competing bids be provided under a rule of auctioneering?

Should a federally imposed period of advance notice be established requiring a bidder to file registration materials with both the SEC and subject company management prior to the implementation of a tender offer?

Are individual shareholders currently receiving adequate and timely notice and information about take-overs (including competing offers)?

Do target corporations currently have sufficiently direct access to all their individual shareholders to conduct a responsible and reasonable defense against a hostile take-over?

It has been suggested that tender offers serve as an effective mechanism to discipline incompetent management and to permit the transfer of productive assets to the control of more efficient management. On the other hand, it has been agreed that the fear of hostile take-overs tends to focus management's efforts on short-run profits while giving less attention to longer term investments needed for economic growth. What role, if any, should federal regulation play in striking the proper balance between these conflicting concerns?

The Chairman and Chief Executive Officer of a company which was a major and successful player in a recent multibillion dollar acquisition contest has embraced the view that "Maybe there's something wrong with our system when .... companies line up large amounts of money in order to purchase stock, when it doesn't help build one new factory, buy one more piece of equipment, or provide even one more job." How, if at all, should federal regulation address this widespread frustration?

We recognize that a number of these issues are outside the direct jurisdiction of the Commission. However, it is our understanding that the Advisory Panel being put together by the Commission to study tender offers will be made up of outside professionals, including economists.

We believe that the public interest and the Congress would be best served by a broad study of the many issues surrounding tender offers and particularly hostile take-overs, and, therefore, we encourage the Commission panel to be comprehensive in both its approach and charter.

On July 13, 1979, the Banking Committee requested the Commission to review 7 specific questions concerning coverage of the Williams Act. The Commission provided its response on February 15, 1980. It would also be helpful if the Advisory Panel could review the questions and answers and provide any updating which the Panel may deem necessary.

To assist us in considering this subject, we would appreciate receiving the study and recommended legislation from the Advisory Panel by July 31, 1983.

Sincerely,

Alfonse M. D'Amato

Paul S. Sarbanes

Slade Gorton

Donald W. Riegle

John Heinz

Christopher Dodd

Paula Hawkins

Alan Dixon

Mack Mattingly

Alan Cranston

Jake Garn, Chairman

William Proxmire
Ranking Minority Member

EXHIBIT B

July 8, 1983

John S.R. Shad
Chairman
Securities and Exchange Commission
Washington, D.C. 20549

Dear Chairman Shad:

We are enclosing the final report of the Commission's Advisory Committee on Tender Offers which was established on February 25, 1983. The eighteen members of this Advisory Committee met six times in full session. Countless meetings of six sub-committees were held to prepare recommendations to the full body. We had the benefit of extensive experience of our individual members in completing our assignment within our original time frame.

The summary report emphasizes that we concentrated our work and recommendations on shareholders' interests. We are cognizant, however, of interest in takeovers on broader governmental, societal, jurisdictional planes and have touched on these issues in our work. We specifically address some questions put to us through the Commission that express Congressional concerns.

Our recommendations are detailed, technical and comprehensive. We expect the Commission to put them in place by rule making or by recommending legislation, or regulation, as may be required, as they stand. They are designed to be an integral and cohesive body.

I would like to point out the fundamental bases upon which our recommendations rest. There are other technical solutions which are consistent with our fundamental policy objectives. Throughout the meetings of the Committee we encouraged diversity of opinion and dissent. One of our functions was to bring out a number of ideas which might otherwise have become buried in a carefully negotiated majority view. We hope the Commission will draw upon this diversity of views in reaching your ultimate decisions.

The Committee respects the free market forces in the operation of the U.S. securities markets. Academic evidence is widespread that the takeover process is at least not demonstrably harmful to shareholders and some evidence points to its systematic benefits. We would be reluctant to restrict a process which seems to work reasonably well with the possibility that we might incur some unintended harm. The Committee is humble in its ability to anticipate all of the

takeover innovations that are likely to occur: good and bad. Our instincts led us to rely upon competitive markets as the ultimate regulator for the unforeseen specifics that may affect security holders. Our recommendations should promote private investment systems rather than hamper capital flows by heavy reliance upon rule making. We are attracted to solutions which are characterized by flexibility, simplicity and lower costs.

A theme running through our recommendations is to promote the disclosure of meaningful information to all investors. The tender offer process seems the best way available to us of insuring that terms, price and conditions are made available equally to all shareholders in a timely fashion. We suggest that purchases above 20% ownership be offered to all shareholders through the tender process.

We resist the temptation to bar substantial partial positions in companies. In most instances, we would expect that the acquisition of control would be accompanied by the purchase of all shares. There are circumstances in this country, as in international markets, where partial participation establishes business relationships which encourage cooperation and productive sharing of skills. We would not wish to alter these affiliations. We do, however, recommend that the partial positions receive somewhat less favored treatment than purchases which are contemplated to be for an entire company.

We are introducing an improvement in shareholder democracy in the form of advisory votes. We do believe that shareholders should have a mechanism to express their periodic will on charter provisions which may limit conditions under which their stock may be sold. Company directors, on the other hand, should not be bound to act against their business judgment in the shareholder interest. We do believe that the advisory vote concept will become a useful device in measuring shareholder sentiments.

We encourage procedures which will equate the offering of cash and securities. A number of purchases are accomplished initially for cash because Commission procedures are simplified for cash, and then are converted later into securities. Should cash and securities be administratively equated in the first instance, the latter potentially cumbersome and expensive step can be eliminated.

Throughout our discussions we have argued for simplicity in the procedures which may be required. This simplification may in some measure counteract the almost natural attraction to an elegance of rule making to guard against a number of perceived evils, especially those of recent anecdotal evidence.

Documentation by academic sources, business reports and the Commission staff were very helpful in our deliberations. We benefited from a review of takeover practices in other countries which included generous personal visits by United Kingdom and Canadian representatives.

The committee would have been unable to complete its work without the competence, diligence and hard work of the staff assigned to it. David Martin, Secretary to the Committee, did excellent work in keeping us administratively on track. Linda Quinn, Associate Director, diplomatically functioned in a continuing and important role.

Finally, we hope that the Commission and its staff will draw upon the Committee members for their advice and counsel in the future as you wish. Although we are disbanded with this report, our interest has not lessened and our willingness to serve remains keen.

Sincerely,

Dean LeBaron
Chairman
Securities and Exchange Commission
Advisory Committee on Tender Offers

EXHIBIT C

17 CFR Part 240

[Release No. 34-21079; S7-24-84]

Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs—Advance Notice of Possible Commission Actions

AGENCY: Securities and Exchange Commission.

ACTION: Request for public comment.

SUMMARY: The Commission is studying two-tier pricing in tender offers and non-tender offer purchase programs. This review has evolved from recommendations proposed to the Commission by its Advisory Committee on Tender Offers. The Commission is requesting public comment on these

recommendations as well as on other proposals, issues and data described in this release. This initiative will assist the Commission in its review of the tender offer regulatory scheme. The Commission will review comments made in response to this release with a view toward possible rulemaking and legislative proposals.

DATE: Comments should be received on or before September 14, 1984.

ADDRESS: Comment letters should refer to File S7-24-84 and be submitted in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549. The Commission will make all comments available for public inspection and copying in its Public Reference Room 450 Fifth Street, NW., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Joseph G. Connolly, Jr. or Robert E. Burns, ((202) 272-3097), Office of Tender Offers, Division of Corporation Finance, or, regarding the Report that is an annex to this release, Gregg A. Jarrell ((202) 272-7102), Chief Economist, Securities and Exchange Commission 450 Fifth Street, NW., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. Executive Summary

The Securities and Exchange Commission (the "Commission") is considering two practices in the change of control area that have raised serious concerns and have come under increased scrutiny. The first is an acquisition, initiated by a tender offer, where the per share consideration is higher for one portion of the shares to be acquired than for the other portion ("two-tier pricing" or a "two-tier bid").[1] The second is the acquisition of a significant percentage of stock through open market or privately negotiated purchases.

The issues surrounding two-tier pricing and non-tender offer acquisition programs have been focused recently by the Report of Recommendations of the Commission's Advisory Committee on Tender Offers.[2] The Advisory Committee identified concerns with these practices and made proposals to address those concerns.[3] The Commission expressed reservations with those recommendations and has initiated a study of the issues in this area.[4] As part of the study, this release discusses concerns regarding two-tier bids and open market or privately negotiated purchase plans. It identifies possible solutions to alleviate these concerns, including the Advisory Committee's recommendations, and requests public comment.

Finally, as a further part of the Commission's study, the Office of the Chief Economist ("OCE") has compiled data regarding successful tender offers in calendar years 1981-1983. This study covers 91 any-or-all, 32 two-tier, and 25 partial tender offers. The data show that the average premium for the any-or-all tender offers is 53.4 percent, compared with an average blended premium of 58.1 percent for two-tier offers, and 31.3 percent for partial tender offers. A closer comparison of any-or-all uniform premiums with two-tier blended premiums shows that 66 percent of the any-or-all offers have premiums above 40 percent, while 72 percent of the two-tier offers have blended premiums above 40 percent. This study is attached as an annex to this release and provides complete detailing of the sample studied and the methodology used. Commentators are requested to comment upon the OCE Report and suggest further research directions.

II. Concerns With the Practices and Recommendations of the Advisory Committee on Tender Offers

A. Two-Tier Pricing

The two-tier bid is a recent practice that has evolved from the partial tender offer. The partial tender offer itself is not new. As a bidding practice it has been used for many years in a variety of ways—standing alone or as part of a series of transactions such as an open market acquisition, followed by a partial tender offer, followed by a final merger.[5] As noted above, of the 148 successful tender offers included in OCE's three-year sample, 32 are two-tier offers, 25 are partial offers and 91 are any-or-all offers. Recently, the partial offer has been amplified by the two-tier bidding strategy where a proposed second step, lower priced acquisition of the minority interests is disclosed in the first step partial tender offer.[6]

Concerns with two-tier pricing pivot principally around what many see as coercion or pressure on shareholders to tender into the first step cash tender offer.[7] The alternative of not accepting the tender offer is virtual assurance that, if the offer is successful, the shares will have to be sold in the lower priced, second step.[8] Given that pressure, it is

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[1] A two-tier bid usually involves an acquisition that is accomplished in two steps. In the first step, the bidder uses a tender offer to buy, at a premium price and generally for cash, enough shares to establish a controlling position in the target. Once control is established, the offeror will take the second step in the acquisition, a merger of the target into the bidder or a subsidiary, freezing out minority shareholders with a forced exchange of cash or securities valued at a lower price than the original tender offer. The second step merger generally is disclosed in the tender offer materials and usually involves securities of the bidder.

[2] Advisory Committee on Tender Offers, *Report of Recommendations* (July 8, 1983) ("Advisory Committee Report"). The Advisory Committee was established by the Commission to examine the tender offer process and other techniques for acquiring control of public issuers and to recommend to the Commission appropriate or necessary legislative and regulatory changes. See Release No. 34-19336 (February 25, 1983) [48 FR 9171, March 3, 1983]. Members of the public may obtain copies of the Advisory Committee Report, on a one per request basis, by sending a self-addressed 9 x 12 inch envelope with prepaid postage of $1.20 affixed, to Securities and Exchange Commission, Publications Section, Public Reference Branch, Stop 1-6, 450 Fifth Street, NW., Washington, D.C. 20549.

[3] Advisory Committee Recommendation 10 proposed that a partial offer have a longer minimum offer period than a bid for all shares. That regulatory disincentive would tend to mitigate what the Committee saw as the coercive elements of partial and two-tier bids. Recommendation 14 proposed that any acquisition resulting in total ownership of over 20 percent of the voting power of an issuer be made by tender offer. Such a provision was intended to ensure equal opportunity for all shareholders to benefit from any premium associated with a control acquisition, an opportunity the Advisory Committee believed was not available where control passed through a non-tender offer acquisition program.

[4] The Commission considered all of the Advisory Committee's recommendations at its open meeting on March 16, 1984. Chairman Shad testified as to the Commission's positions on March 20, 1984 before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce. The Commission is now engaged in a three part response to the Advisory Committee's Report: first, proposed legislation (see Tender Offer Reform Act of 1984 (H.R. 5693, 98th Cong., 2d Sess. (1984)) submitted by the Commission to Congress on May 23, 1984 and introduced on May 25, 1984); second, proposed rulemaking; and third, further study on certain issues.

[5] See, e.g., Freund & Easton, *The Three-Piece Bid/or: An Alternative Approach to Negotiated Corporate Acquisitions*, 34 Bus. Law. 1879 (1979).

[6] Some, including certain members of the Advisory Committee, argue that even the pure partial offer is a two-tier bidding strategy, where the first step is a cash tender offer and the second step is the open market.

[7] The OCE Report compares the first- and second-tier premium in two-tier offers to determine if first-tier premiums encourage shareholders to tender into an offer with a lower second-tier premium. OCE finds that the second-tier premium equals at least 80 percent of the first-tier premium in over three-fourths of the cases and most second-tier premiums are equal to or least 90 percent of the first-tier premium. The average first-tier premium in two-tier offers is 62.5 percent, and the average second-tier premium is 47.1 percent. The average bid premium in partial tender offers is 43.8 percent. The Commission notes, however, that the OCE Report does not attempt to determine the extent to which "market professionals" or any other group of shareholders of a target may receive a disproportionately high percentage of the first tier premium.

[8] The pressure based on price differential in the first and second step can be accentuated where the considerations in the second step is securities whose market value may be less than stated value.

argued that there is no realistic means for shareholders to reject a two-tier bid, even where they believe the combined, or blended, first and second step price for the target is too low.[9]

The Commission's Advisory Committee on Tender Offers identified many of these concerns with coercive effects of two-tier bids. Indeed, the Advisory Committee considered these concerns to be applicable to partial offers as well. The Committee proposed that a regulatory disincentive be placed on all partial offers. That disincentive would be substantially longer minimum offering period than that applicable for an offer for all shares ("full bid").[10] This was expected not only to encourage the use of the full bid but also of offset to some degree the advantage of a two-tier bid.

The Advisory Committee envisioned an extension of the offering period for a partial bid beyond the current, 20 business day minimum offering period for a full bid.[11] The concept of different time periods for partial and full bids, however, could also be implemented by reducing the full bid period and leaving partial offers on the current time schedule. For instance, the minimum offering period for a full bid could be reduced to 10 business days, and the partial offer could be left at 20 business days. Commentators are specifically requested to address this alternative along with that of the Advisory Committee.

The Commission is sensitive to the Committee's concerns regarding two-tier and partial offers. At its meeting on March 13, however, the Commission stated that it did not think the Committee's recommendation is the best way to address these concerns. The Commission's reservation is based on a number of points.

First, the Commission is not satisfied that the case for the supposed coercion in a two-tier bid has been made with sufficient precision. In this regard, the Commission notes that any tender offer, and particularly any partial tender offer, involves an element of coercion or pressure. The Commission requests commentators to address specifically cases in which two-tier bids have created pressure on shareholders which is different than that present in other tender offers.

Second, assuming that the two-tier bid is unduly coercive, the Commission is not certain that the two week extension of the minimum offering period for the partial offer recommended by the advisory Committee is a strong enough response. Currently, there is a timing disincentive for the partial bid. This arises from the ability of a bidder in a full bid to begin purchases upon the termination of the withdrawal rights. With a partial offer, purchases cannot commence until the expiration of the offer.[12] Notwithstanding this disparity, however, it is not clear that it has discouraged bidders from using the two-tier bidding strategy. Commentators are requested to address this point specifically in their comment letters.[13]

Third, aside from questions about the effectiveness of the proposal, the Commission is concerned with any regulation that does not distinguish the two-tier bid from the partial offer. The partial tender offer has long been an accepted bidding practice which can serve valid business purposes.[14] The Commission specifically requests commentators to discuss whether it is appropriate to regulate two-tier bids in a way that would also regulate partial offers. Further, it requests comments on whether in is possible to formulate regulation that distinguishes between partial and two-tier offers.

Fourth, the Commission believes that any restriction on two-tier pricing must appreciate the impact of the regulation on broader corporate control transfer issues. For instance, if two-tier bidding is restricted, will there be fewer bids made? Or, alternatively, will restrictions on two-tier bidding simply force bidders into pure partial tender offers with no second step into which minority shareholders can sell? The OCE study shows that any-or-all tender offers are common for small target firms, while partial and two-tier offers predominate among larger targets, as measured by the market value of equity. If two-tier bidding is restricted, will the distribution of tender offers by firm size change?

Finally, the Commission believes there is some indication that recent regulatory changes and proposals may effectively reduce the appeal of two-tier pricing for bidders. Since the Commission adopted Rule 14d-8 (*see* Release No. 34-19336 (December 15, 1982)), which eliminated the use of multiple proration pools by requiring that proration rights be extended throughout the offering period of any partial offer, there has been a decline in the use of two-tier pricing in tender offers. *See* OCE Report. Futher, the Advisory Committee proposed, and the Commission concurred, that cash and exchange offers be placed on a more equal regulatory footing.[15] Under current regulations, because of the need to register securities to be offered in exchange, the Advisory Committee found that there was major disincentive to using securities as consideration in a tender offer. To the extent that regulatory disincentives are reduced for exchange offers,[16] the Commission requests comment on whether bidders may find it less necessary to structure bids with a high cash front end and a lower priced securities back end or whether bidders may have greater flexibility to design other forms of two-tier bids.

B. Open Market or Privately Negotiated Purchase Programs

The second area the Commission is studying involves the acquisition of a

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[9] Its effective is the pressure of the two-tier bid, some have theorized, that it is possible for a two-tier bid with a lower blended price to prevail over a higher priced offer for all the shares. This may result because the risk of proration in a two-tier offer is reduced by the likelihood of shareholders tendering into the competing bid and the fact that a percentage of shareholders may not tender into either offer. On the basis of the 1981–1982 data in the OCE Report, there is no evidence of a two-tier bid with a lower blended price prevailing over a higher priced offer for all the shares. *See* section V of OCE Report.

[10] *See* Advisory Committee Report at Recommendations 10 which provides as follows:

> The minimum offering period for a tender offer for less than all the outstanding shares of a class of voting securities should be approximately two weeks longer than that prescribed for other tender offers.

[11] *See* Rule 14e-1 (17 CFR 240.14e-1).

[12] Under Rule 14d-7 (17 CFR 240.14d-7) any person who has deposited securities in a tender offer has a right to withdraw those shares for the first 15 business days of the tender offer. Thus, after that, the bidder in an offer for all the outstanding securities may commence purchasing. Where the offer is for less than all the shares, however, Rule 14d-8 (17 CFR 240.14d-8) requires proration rights to be extended throughout the offering period. The bidder, therefore, cannot commence purchases until the expiration of the offer because it cannot determine the proration factor until the offer expires.

[13] In addressing this point, commentators should note that the Advisory Committee recommended, and the Commission concurred, that withdrawal rights be extended throughout the offering period. *See* Advisory Committee Report at Recommendation 17. The Commission will make this the subject of a separate rulemaking proposal.

[14] There was substantial continent on the Advisory Committee itself that partial tender offers are important to the economy. The Report cited six valuable roles for partial offers. *See* Report at pp. 50–58.

[15] *See* Advisory Committee Report at Recommendations 5, 11, and 12.

[16] The Commission has proposed for comment a new form, Form S-4, for registration of securities in business combinations which, if adopted, would implement the Advisory Committee's proposal to extend principles underlying the integrated disclosure system to exchange offers. *See* Release No. 33-6534 (May 8, 1984) [49 FR 20333]. Another element of the Advisory Committee's recommendation which involves commencing bids and receiving tenders prior to the effective date of the registration statement will be the subject of a separate rulemaking project.

significant position through open market or privately negotiated purchases. Concern here is raised by the fact that where such purchases do not involve a tender offer [17] and where control passes as a result of the purchases, there are not the same substantive protections as would be present if the acquisition had been by tender offer. In a tender offer, the bidder must provide disclosure about the offer, keep the offer open for a minimum period of time, provide the substantive protections of withdrawal, proration and the best price rule, and make the offer to all shareholders. The tender offer procedure and regulations will assure that market forces will price the premium and that this premium is offered to all shareholders. Those same assurances do not exist in ordinary open market or privately negotiated purchase programs which are regulated essentialy from a disclosure standpoint.[18] Thus, although it may have substantially the same effect as a tender offer, the open market or negotiated acquisition program has the tendency to proceed with the lowest control premium and to pass that premium to a selective group of shareholders.[19]

Additional regulation of these acquisitions has been proposed form time to time by the Commission [20] and was addressed by the Advisory Committee specifically. The Advisory Committee proposed that any acquisition resulting in total ownership over 20 percent of the voting power of an issuer be required to be made by a tender offer.[21] Above the 20 percent threshold, this proposal would eliminate concerns of those who believe open market or privately negotiated purchase programs unfairly and unevenly set and distribute control premiums. The recommendation is founded on the premise that control is a corporate asset and that shareholders should have an equal opportunity to share in the premium paid for that asset.[22]

At its meeting on March 13, the Commission expressed serious reservations about the Committee's proposal. Principal among the drawbacks with such a proposal is the regulatory burden that it would place on all forms of acquisition that result in more than percent ownership, even those where control is not the ultimate objective. For instance, the proposal could inhibit such acquisitions as those for investment or technology transfer purposes by increasing the expense of assembling such holdings and by decreasing the alienability of blocks in excess of 20%. The proposal, which would represent a fundamental change in the current system, could have significant impact on capital formation and corporate governance. The Advisory Committee itself acknowledged the difficult issues that such a proposal would present, noting its own "extended debate" on the question.

III. Alternative Proposals

In addition to the proposals of the Advisory Committee and the legislative and rulemaking proposals of the Commission in 1979 and 1980,[23] three alternative proposals have been made to address two-tier bids and non-tender offer acquisition programs. The first would require a bidder to make a tender offer for all the shares of a class once holdings in that exceed a certain threshold. The key determinant with this suggestion is the level of the trigger threshold. Various proposals have ranged from as low as 10 percent to as high as 30 percent. As noted by the Advisory Committee, under the regulation of takeover bids in the United Kingdom, the City Code on Take-overs and Mergers ("City Code") imposes a general obligation to make an offer for all shares if the amount owned or sought exceeds 30% of the outstanding shares.[24]

Consequences of this type of regulation, which combines certain policy elements of the Advisory Committee's Recommendations 14 and 16, are similar to those already described. A system that requires the tender offer to be used above a certain threshold could increase the costs of toe-hold acquisitions and restrict the alienability of blocks. Moreover, a system that requires a tender offer for all the shares above a certain threshold could limit partial ownership of companies, an economic consequence of uncertain limits. In addressing this alternative commentators are requested, if they believe a threshold is appropriate, to indicate at what level they would place it and why.

The second proposal also derives from the British system of regulation. Under the City Code, a letter of transmittal by which target company shareholders respond to an offer must provide an opportunity to approve or disapprove an offer for less than all of the outstanding shares.[25] The tender offer reply form thus permits the shareholder to exercise two choices in response to the bid. First, the shareholder may tender or not tender shares that are the subject of the offer. Second, the shareholder is permitted to vote for or against the offer. If a majority of the shareholders vote against the offer, the shares will be returned and the bid will not be permitted to proceed. Thus, in the case of a partial offer, including an explicit two-tier priced offer, a shareholder may tender shares and vote against the transaction at the same time.

This type of provision appears to eliminate effectively the perceived coercive aspects of the two-tier bid that have evoked concern. A shareholder who is not satisfied with the price of the offer, in either the first or the second step, but who feels compelled to tender shares into the first step tender offer, may at the same time protect his or her position by voting against the offer. To the extent that the market as a whole concurs, the regulatory system would

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[17] Courts have found that certain purchase programs constitute tender offers. *See, e.g., Wellman v. Dickinson*, 475 F.Supp. 783 (S.D.N.Y. 1979); *S-G Securities, Inc. v. Fuqua Investment Co.*, 466 F. Supp. 1114 (D.Mass. 1979); *Cattleman's Investment Co. v. Fears*, 343 F.Supp. 1248 (W.D.Okla. 1972).

[18] *See* 16(b) and 13(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) (the "Exchange Act"). Section 16(b) is the general antifraud provision of the Exchange Act. Section 13(d) requires certain disclosure within 10 days after an acquisition that results in a beneficial ownership of more than 5% of an issuer's registered equity securities. Recently, the Commission has proposed legislation that would empower it to close the 10-day window period in section 13(d). *See* H.R. 5693, 96th Cong., 2d Sess. (1980). That legislative proposal was in direct response to Advisory Committee Recommendation 13.

[19] For a general discussion of the impact on target shareholders of the open market or privately negotiated acquisition program, see Mainwaring & Tobin, *Beachhead Acquisitions: Creeping Waves to the Marketplace and Uncertainty in the Regulatory Framework*, 32 Bus. Law. 635, 635–39 (1980).

[20] In 1979, the Commission proposed a regulatory structure that would require the use of a tender offer for an acquisition above a specified threshold of beneficial ownership. *See* Release No. 34-16385 (November 29, 1979). Those rules were not adopted. In 1980, the Commission proposed legislation that would have effected a similar result. *See* S. 2160, 96th Cong., 2d Sess. (1980). The legislation was not enacted. *See also* note 17.

[21] *See* Advisory Committee Report at Recommendation 14 which provides as follows: No person may acquire voting securities of an issuer, if, immediately following such acquisition, such person would own more than 20% of the voting power of the outstanding voting securities of that issuer unless such purchase were made (i) from the issuer, or (ii) pursuant to a tender offer. The Commission should retain broad exemptive power with respect to this provision.

[22] The question whether control should be deemed a corporate asset has been debated for some time. *See, e.g.*, Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505 (1965); Berle, *"Control" in Corporate Law*, 58 Columb. L. Rev. 1212 (1958). *See also* Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

[23] *See* note 18.

[24] *See* Rule 34 of the City Code.

[25] Under the City Code, partial offers are permitted under certain circumstances. *See* Rule 37 of the City Code.

provide a mechanism for the coalescence of that estimate.

A third approach would permit partial offers but would require any second-step acquisition within a specified period to be of at least equal per share value. Under this proposal, a bidder could make a partial tender offer. Any further acquisitions within a specified period, two years for instance, whether by merger, tender offer, or non-tender offer purchases, would only be permitted if the consideration was of at least equal value per share as that given in the first step partial tender offer. This proposal would mitigate against the perceived coercive effects of both partial and two-tier offers by eliminating the price differential between the initial tender offer and the second step take-out merger or the open market absorption of minority interests.

IV. Specific Questions

In addition to Advisory Committee Recommendations 14 and 16, the alternative proposals described in Part III, and other specific inquiries in Parts II and III, commentators are requested to consider the following questions.

1. Is two-tier pricing an acceptable means to induce tendering?

2. Is a two-tier offer coercive, and, if so, how and in what situations is it most coercive?

3. Does the partial offer with no stated second step involve less certainty and more coercion than the explicitly two-tier bid, and if so, explain how?

4. Is it possible to regulate two-tier offers without also regulating partial offers, and, if so, how?

5. Is a partial offer inherently more complicated than an offer for all shares, and, if so, is it necessary to keep a partial offer open longer than a full offer in order to give shareholders time to evaluate its terms?

6. If regulation restricted bidders to using only tender offers for all shares, would this have a chilling effect on takeover activity and, if so, how?

7. As a conceptual matter, should "control" in any form be deemed a corporate asset, and why?[20] If so, for what form of "control" is that premise most apt?

8. Should federal regulation be structured around the premise that "control" is a corporate asset, and, if so, what system of regulation is most appropriate?

9. What are the principal benefits and detriments to an open market or privately negotiated acquisition program to obtain control?

[20] See note 21.

10. If a non-tender offer acquisition program occurs over a long period of time and incremental acquisitions are fully disclosed, are there still adverse consequences that require additional regulation?

11. Should the regulatory scheme assure that the tender offer is the fastest means to acquire a substantial percentage of an issuer's equity?

12. What would be the economic consequences of a regulation that prohibited open market acquisitions above a certain threshold, and required that above that threshold any acquisition be made by a tender offer?

13. Some reason that, from an economic standpoint, the partial offer should always have a higher premium than the full offer. Assuming this is true, if the initial bid is two-tier priced, will the high premium in the first step partial tender offer necessarily force a subsequent competing bidder to use a two-tier bid, as opposed to a full bid. If so, why? If not, why not?

14. It has been argued that the partial offer can induce shareholders to accept less than the best alternative. Is that argument apt and if so, would a requirement that target company shareholders approve a partial tender offer in the manner described in Part III resolve the predicament?

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Dated: June 21, 1984.
By the Commission.

George A. Fitzsimmons,
Secretary.

The Economics of Partial and Two-Tier Tender Offers

Concern over partial and two-tier tender offers is very evident. The Securities and Exchange Commission's Advisory Committee on Tender Offers noted those concerns and suggested possible regulatory changes. Recent legislative proposals would severely hinder the use of partial or two-tier tender offers. Before regulatory changes are pursued however, a comprehensive economic analysis of partial and two-tier tender offers is required. In this paper, we consider tender offers in 1981, 1982 and 1983, and relate empirical information on partial and two-tier tender offers to the controversy surrounding them.

Our attention is focused on the premiums paid to target shareholders in partial or two-tier offers as opposed to any-or-all offers. A predominant concern when any-or-all offers are not used is that target shareholders may be encouraged to tender in the first tier when the offer price of the second tier is substantially lower (or nonexistent in partial offers). We compare the overall "blended" premium in partial and two-tier tender offers (a weighted average of first- and second-tier premiums) to any-or-all premiums to determine relative premiums paid to target shareholders in each case. In addition, we note other characteristics of partial and two-tier offers. Frequency of these offers over time and possible rationale for such offers are considered.

This memorandum is organized into several sections. The first section is a brief overview of the criticism of partial and two-tier offers. The second section describes our data and empirical methodology. The third section considers some theoretical explanations of partial and two-tier tender offers. The fourth section relates our empirical information to the controversy. Section five reviews multiple bidder contests. A summary and conclusion ends the paper.

Our study reveals these characteristics of any-or-all two-tier and partial tender offers in 1981, 1982 and 1983:

- Any-or-all offers are more frequent than partial and two-tier offers (91 as opposed to 57). However, the incidence of any-or-all offers is much higher among smaller targets while partial and two-tier offers predominate among medium-size and large targets.
- Any-or-all offers yield a higher overall premium (83.4 percent) than the blended premiums in two-tier (55.1 percent) and partial (31.3 percent) offers. Any-or-all premiums and two-tier blended premiums are very similar in magnitude—72 percent of two-tier premiums exceed 40 percent while 68 percent of any-or-all premiums do so.
- The first-tier of a two-tier offer is virtually equal to the overall premium of an any-or-all offer at 83.5 percent. However, the offer premium of partial offers is lower at 45.9 percent.
- Nearly three-fourths of the 32 two-tier offers have less than a 20 percent difference between the first- and second-tier premiums. In contrast, less than half of the 25 partial offers have less than a 20 percent difference between the offer price and the post-offer trading price.

I. The Controversy Behind Partial and Two-Tier Tender Offers

In Release No. 34-21079, the Commission describes the concerns surrounding partial and two-tier offers. Central to these concerns is that target shareholders may be induced to tender

to a partial or two-tier offer when an alternative any-or-all offer may have a higher overall premium. A two-tier offer might be accepted over an any-or-all offer in this case because shareholders tender to a high first tier to avoid a relatively low second tier. Though shareholders would be better off on an overall basis if they tendered to the any-or-all offer rather than tendering to the two-tier offer, shareholders are not certain which offer will be accepted. A situation is created where shareholders may tender to the first tier of the two-tier bid because of fear of being forced to accept a lower second-tier offer if the bidder obtains control in the two-tier offer. Commentators suggest that this process is coercive and encourages shareholders to tender when the overall two-tier premium is not as attractive as existing or potential any-or-all offers.

Our research focuses on identifying partial and two-tier offers and computing any-or-all, first-tier and "blended" premiums (which combine first-tier and second-tier premiums).

These premiums are compared for evidence of shareholders accepting relatively low overall bids in partial or two-tier offers or indications of coercive behavior. In addition, the frequency of such offers and the role of these offers in takeovers are studied. It is hoped that the evidence presented will provide a springboard for further discussion and research.

II. Data and Methodology

The debate surrounding partial and two-tier offers lacks empirical evidence. Although commentators from investment banking firms and other industry sources are very knowledgeable about partial and two-tier offers, there has been no data compiled to specifically address the empirical questions arising in this issue.

The Austin data base compiles all tender offer filings at the Commission and provides details on offer terms and target characteristics.[1] From this data base, we take all "successful" cash offers (defined as those in which some target shares were purchased) in 1981, 1982 and 1983.[2] For these offers, we compile a data base detailing offer terms, pre- and post-offer prices of target shares, and other information such as total number of target shares and number of shares held and sought by the bidder.[3]

In general, tender offers may be divided into two basic groups depending on whether prorationing is a factor in the bid. An any-or-all offer states that the bidder will buy any-or-all tendered shares of the target firm, as long as some minimum conditions are met. In general, such conditions related to a minimum number of tendered shares to insure control. In an any-or-all offer, the target shareholder knows that all of his tendered shares will be purchased at the offered premium as long as the minimum conditions are met.

The second type of tender offer is one in which the bidder states a maximum number of shares to be purchased in addition to a minimum condition. If the offer is oversubscribed, the tendered shares will be subject to prorationing. When the offer is executed under prorationing, each tendering account has the same fraction accepted. Prorationing requirements insure that each target shareholder receives proportionate share of the terms of the tender offer.

This second type of offer may be divided into several subgroups. A *pure partial offer* we define as one in which there is no announced second-tier offer during the tender offer and no clean-up merger of tender offer closely following the execution of the tender offer. Assuming the partial offer is for control off the target firm and is successful, a minority interest is left trading the target firm's shares in the market. Following the execution of the tender offer, it should be noted that the trading price is generally lower than the offer price. This trading price of the target shares is essentially the second tier of a partial offer.

A two-tier offer combines a partial tender offer for control with an offer for remaining shares following the execution of the original tender offer. In an *explicit two-tier* offer, the bidder, at the time of the first-tier offer, agrees with target management to purchase the remaining shares following the execution of the first-tier. The first tier usually is for controlling interest in the target firm and almost always offers cash for the target shares. The second tier is more likely to offer securities for the remaining shares after the cash first-tier offer closes successfully. The first-tier price is offered to shareholders on a prorata basis and the value of the second-tier offer is less than the first-tier offer on a per-share basis.

An *implicit two-tier* offer lies between the pure partial offer and the explict two-tier offer. Though no second tier is agreed to at the time of the original offer for control, a second tier is revealed shortly after the execution of the offer. The second-tier price in implicit two-tier offers is again generally lower than the first-tier price and offers securities for the target shares. The second-tier offer often takes the form of a merger.

Central to our research is the determination of premiums paid in the various categories of tender offers. The premium of the any-or-all offer is simply the precentage difference between the tender offer price and the pre-offer price:

$$(1)\ P_A = (P_T - P_M)/P_M$$

Where:

P_A = any-or-all tender offer premium,
P_T = price offered for target shares, and
P_M = pre-offer market price of target shares.

The premium of partial and two-tier tender offers is more difficult to determine. The "blended" premium we compute reflects the overall premium paid to all outstanding shares, where the premium paid to each tier is weighted by the fraction of shares receiving that premium. This blended premium is applicable to pure partial, explicit two-tier and implicit two-tier offers. In a pure partial offer, the price of the remaining tradéd shares is essentially the second-tier price. We express the blended premium as:

$$(2)\ P_B = (F \times T_1) + [(1-F) \times T_2].$$

Where:

P_B = the blended price of the offer,
T_1 = the per-share, first-tier offer price,
T_2 = the per share, second-tier offer price,
F = the fraction of outstanding shares demanded through the first tier of the offer,
$T_1 = (T_T - P_M)/P_M$,
$T_2 = (T_2 - P_M)/P_M$, and
P_M = pre-offer market price of target shares.

Most of the needed data is readily available. The tender offer price in any-or-all offers (P_T) and the first-tier price (T_1) in partial and two-tier offers is stated in the terms of the tender offer. The fraction of outstanding shares sought (F) is measured as the fraction of

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[1] *Tender Offer Statistics, 1971–1983*. Douglas Austin & Associates, 5178 Republic Blvd. N., Suite 3, Toledo, Ohio 43615, 1984.

[2] In our study, we do not distinguish explicitly between "friendly" and "hostile" offers. In many cases, the target management has agreed to the bidding firm's offer terms. This is especially true in the case of two-tier offers when the second-tier terms are stated at the time of the first-tier offer.

[3] For our study, we augment the Austin data base with more detailed information from the *Wall Street Journal*. In a few cases it was necessary to eliminate a tender offer from our sample due to lack of contemporaneous price information about the target firm. Tender offers were also excluded if they were clean-up offers after the bidder had already obtained control of the firm. A list of excluded offers is available upon request.

Mergers, as opposed to tender offers, are specifically excluded from our sample. For example, in the complicated Martin Marietta/Bendix case, we include only the various tender offers in which shares were purchased. These offers include Martin Marietta's offer for Bendix and Bendix's offer for Martin Marietta. United Technologies friendly tender offer for Martin Marietta is not included because no shares were purchased under it and Allied's merger with Bendix is also excluded since no tender offer was involved.

outstanding shares purchased in the first round of the tender offer. The pre-offer market price of the target shares (P_{pre}) is measured 20 trading days before the announcement of the initial offer of the contest. This earlier price is used to lower the probability that leakage of information about an impending tender offer has raised P_{pre} above its value in the case of no tender offer.

The second-tier or clean-up price (T_s) is more difficult to determine. In cases where the second-tier offer is composed of securities, the actual security value may not equal that stated by the bidder. In implicit two-tier offers, the value of T_s is not known until the second-tier offer is made. In pure partial offers, the second-tier price is essentially the post-offer trading price of the target shares. For uniformity in comparing these offers, we estimate T_s in each type of offer as the market price of target shares 20 trading days after the execution of the initial offer.[5]

III. Why Bidders Use Partial and Two-Tier Tender Offers

The formula for the blended premium of a partial or two-tier offer can be used to show that any partial offer has a matching any-or-all offer in which target shareholders receive the algebraically equivalent premium. For example, a two-tier offer of $20 for 50 percent of the outstanding shares and $10 for the other 50 percent is algebraically equivalent to a uniform offer of $15 for any-or-all shares outstanding. The premium of the any-or-all offer equals the blended premium of the two-tier bid. Total outlay to the acquiring firm is equal under these bids assuming both induce 100 percent tenders. What are the economic differences, then, between partial and two-tier offers and any-or-all offers, and why are partial or two-tier tender offers preferred by some bidders? Several explanations have been suggested:

1. A partial tender offer leaves outstanding a minority equity interest in the target firm with the value of the outstanding shares determined in a competitive exchange market. In its report, the SEC Advisory Committee on Tender Offers cites several benefits of partial offers in addition to those listed below.[6]

2. The acquirer wishes to limit the financial risk of the takeover bid. An any-or-all tender offer exposes the bidder to financial risk because it is difficult to predict with precision how many shares will be tendered in response to a particular offer. The total outlay required to obtain control depends on the offer price and the number of shares purchased. Because the bidder must choose the offer price before he knows the number of shares tendered, and because an any-or-all offer requires the bidder to purchase all tendered shares as long as the minimum conditions are met, the total outlay for the bidder seeking control cannot be known precisely in advance.

In contrast, a partial tender offer obligates the bidder to purchase only up to a pre-set maximum number of shares regardless of how many shares are tendered, as long as the minimum conditions are met. The partial offer sets an upper bound on the total outlay required for control and eliminates this source of financial risk to the bidder.[7]

3. A two-tier offer can increase the incentive for target shareholders to tender by offering a high first-tier premium and a relatively low second-tier premium. The greater the difference between the first-tier premium and the second-tier premium, the greater is the opportunity cost to target shareholders of not tendering if the offer succeeds. Under certain conditions, target shareholders can be induced to tender into a two-tier offer even though its blended premium is less than the uniform premium of an alternative any-or-all offer that is forthcoming. As identified by Professor Bradley, this situation is analogous to the classic prisoner's dilemma.[8]

The prisoner's dilemma analysis as applied to two-tier tender offers is clearer with an example. Suppose a target firm with 1,000 outstanding shares has a market value of $10 per share before the tender offer, for a total equity value of $10,000. Assume that a bidder is willing to pay $5,000 above this market value for control of the target firm. Therefore, the bidder is willing to pay $15 per-share in an any-or-all offer. Let us further assume that there is a strong expectation that in the near future (say 30 days) another bidder will offer $18 per share through an any-or-all offer.

Despite the expectation of a higher offer in the near future, the first bidder can fashion a two-tier offer to pressure target shareholders into responding while still paying only a $5,000 premium. Specifically, the first bidder offers $20 per-share for 500 shares on a proration basis, and $10 per share for the other 500 shares, to be paid after the first offer is executed. The blended price is $15, which equals the outlay in an any-or-all offer of $15 per share.

Faced with this offer, each target shareholder will reason that: (i) if other shareholders tender, then I should tender to avoid receiving only $10 for my shares; (ii) if other shareholders hold, then I should tender to receive the first-tier price of $20 per-share, with little prorationing risk if the offer succeeds. This reasoning will lead rational shareholders to tender. The result holds even though all shareholders know that concerted, organized refusal to tender would be the best strategy since it would allow by assumption all to receive $18 per share in the near future from an alternative bidder. The prisoner's dilemma that is created by the two-tier offer causes the shareholders to accept the lower-valued offer having a $15 blended price.

We studied all control contests involving partial or two-tier offers in 1981, 1982 and 1983 for evidence that any-or-all offers are disadvantaged relative to partial or two-tier offers in contests or that shareholders may be accepting a lower return by approving a partial or two-tier offer. As detailed in section V, there are no cases which support the suggestion that two-tier or partial offers can defeat competing any-or-all offers while providing lower premiums to target shareholders. Thus, though theoretically a two-tier offer can force the acceptance of a lower-valued offer, we find no cases where this actually happened.

4. Under SEC regulations in effect before December 15, 1982, a two-tier or partial tender offer forced shareholders to commit to tender their shares earlier

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[5] In the case of exchange offers, it is especially important to use the market value of the target stock rather than the stated value of the securities offered. Shareholders will base their decisions on the market value of the securities, not the value as stated by the bidder.

[6] SEC Advisory Committee on Tender Offers, *Report of Recommendations*, July 8, 1983, pp. 24-28.

[7] Uncertainty about how many shares will be tendered in response to an any-or-all offer can create considerable risk. For example, the total outlay for control doubles if 100 percent of outstanding shares are tendered compared with 50 percent. In view of the large per share premiums offered and the large investments represented by many tender offers the incentive can be great for the bidder to put a ceiling on the total outlay required by the tender offer.

[8] Michael Bradley, "Interfirm Tender Offers and the Market for Corporate Control," *Journal of Business*, 1980, pp. 345-376. See especially pp. 359-366. The prisoner's dilemma is created by placing two suspected perpetrators of a crime in separate rooms and presenting each with the following proposition. If you confess and your partner does not, he receives the harshest punishment and you go free. If he confesses and you do not, then you receive the harshest punishment and he goes free. If both confess, then both receive moderate punishment. The rational prisoner will confess to avoid the harshest punishment, even though no confession results in both going free.

than they would under an any-or-all tender offer. This incentive resulted from the SEC's increase in the minimum offer period from 10 calendar days to 20 business days in 1979. At the same time, the minimum period for the proration pool remained at 10 calendar days. Therefore, while an any-or-all offer gave target shareholders 20 business days to make their tendering decisions, the partial or two-tier offer forced target shareholders to decide within 10 calendar days or forfeit their right to prorata acceptance of their tendered shares.

Earlier commitments by target shareholders benefit the bidding firm because target shareholders have less time to consider alternatives or wait for additional offers. This advantage to bidders of prorated offers have been eliminated since December 15, 1982, when the SEC extended proration rights throughout the offering period. We measure a moderate reduction in the incidence of two-tier and partial tender offers relative to any-or-all offers following this rule change.

IV. Empirical Results

A. Frequency of Tender Offers

Table 1 presents a breakdown by year and type of 148 tender offers in 1981, 1982 and 1983. There are 91 any-or-all offers accounting for 61 percent of the total. There are 57 partial and two-tier offers accounting for the remaining 39 percent. The relative incidence of any-or-all offers is roughly constant across the three years, with a modest increase at 66.7 percent of the total in 1983. Two-tier and partial tender offers accounts for at least one-third of the total in each of the three years.

B. Size of Target Firms

Table 2 reports the average size of target firms by type of tender offer. Any-or-all offers are used generally for smaller target firms than either two-tier or pure partial offers. Target firms of any-or-all offers average $113.7 million in total equity value, as measured using the pre-contest stock price times the fully diluted number of shares. In contrast, targets of two-tier offers average $631 million and targets of pure partial offers average $353.8 million.

Tables 3a, 3b and 3c provide more detailed information on the distribution of target size by type of offer. Table 3a shows the absolute distribution of target size by type of offer and Table 3b reports the relative distribution of the same information. These tables reveal that 87.5 percent of two-tier offers and 80 percent of pure partial offers are for target firms of more than $40 million in equity value. On the other hand, only 46.2 percent of any-or-all offers are for these larger firms.

Table 3c reports the percentage of each type of offer in each class of target size. As the size of the target firm increases, two-tier and pure partial offers become increasingly prevalent and any-or-all offers play a lesser role. For target firms with less than $5 million in equity value, 93 percent of the 14 tender offers made are any-or-all offers. For the very largest firms (more than $320 million in equity value), only 25 percent of the 20 offers are any-or-all offers, while 75 percent are two-tier and pure partial tender offers. Clearly, two-tier and pure partial tender offers play an important role in takeover contests for medium-sized and large targets while any-or-all offers are used mainly for smaller targets.

C. Premiums in Tender Offers

1. *Any-or-All and Blended Premium.* The any-or-all and blended premiums for the three different types of tender offers are compared by year in Table 4. The three year average show that the mean premiums for any-or-all offers is highest at 63.4 percent, compared with a moderately lower blended premium of 58.1 percent for two-tier offers. Partial offers yield a much lower blended premium of 31.9 percent.

Through the average premium for any-or-all offers is higher than the average blended premium for two-tier offers, a closer look at the distribution of premiums (Tables 5a and 5b) reveals the similarity between the magnitude of any-or-all and two-tier premiums. For example, 72 percent of two-tier blended premiums are greater than 40 percent while 66 percent of the any-or-all offers exceed 40 percent premiums. Therefore, we do not find a substantial difference between any-or-all premiums and blended two-tier premiums.

2. *Bid Premiums.* The bid premium is defined as the overall premium in any-or-all offers and the first-tier premium for tow-tier and partial offers. As shown in Table 6, the bid premium is virtually identical for any-or-all and two-tier offers at 63 percent. The pure partial offer premium is 45.9 percent. Referring back to blended premiums, it is clear that the blended premiums in two-tier and pure partial offers are less than the corresponding bid premiums. Clearly, the generally lower second-tier price pulls down the blended premium, especially for partial offers.

3. *First-Tier and Second-Tier Premiums.* Table 7 divides the blended premiums of two-tier and pure partial offers into its components—the first-tier and second-tier premiums. In every year the mean second-tier premium is positive for both two-tier and for pure partial offers, indicating that the market value of the second tier generally exceeds the pre-offer market price of the target. The average second-tier premium is 47.1 percent for two-tier offers and 18.6 percent for pure partial offers. These second-tier premiums are clearly substantial on average.[8]

Table 8 reports data on the difference in magnitude between first-tier and second-tier premiums. This computation addresses the concern that target shareholders are induced to tender to two-tier and partial offers because of large differences between the values of the two tiers. The first-tier premium is 14.5 percent larger than the second-tier premium for two-tier offers on average. For partial offers, the first-tier premium is 28.7 percent larger than the second-tier premium on average. In two-tier offers, this difference between the value of the two tiers is not very large, especially when compared to the difference in pure partial offers.

Table 8 provides a detailed breakdown of the relative difference between the value of the two tiers in two-tier and pure partial offers. The second-tier premium is no more than 20 percent less than the first-tier premium for 72 percent of the two-tier offers. For partial offers, the second-tier premium is no more than 20 percent less than the first-tier premium in 46 percent of the cases.

V. Multiple Bidder Contests

We survey the outcomes of multiple-bidder contests for corporate control between 1981 and 1983 with a view toward the question of whether partial or two-tier offers have an unfair advantage vis-a-vis other kinds of offers. Table 9 lists a total of 26 contests, in alphabetical order of the target firm's name. This table accounts for all multiple-bidder control contests between 1981 and 1983 in which at least one offer was a partial or two-tier tender offer.[9] There are a total of 62

[8] The second-tier price of target shares has not been purged of overall market trends. T_2 will more accurately reflect changes in share value due strictly to the tender offer when the market model is used to extract out overall market influences.

[9] There is one notable control case which is not included in this table—the Bendix case. There were two tender offers simultaneously on the table in that contest: United Technologies made a formal tender offer for Bendix which was exactly the same as the Martin Marietta bid in terms of percent sought and price per share. However, it was made as a fallback bid rather than as a competing bid despite the fact that its effective date was only eight days later than the Martin Marietta withdrawn date. The United Technologies offer was specifically designed so as not to lure any shares away from the Martin Marietta proration pool, i.e., so as not to compete

bidders, for an average of 2.4 bidders per target. Seventeen of these bidders (27 percent) made any-or-all offers. For these purposes, we count a merger proposal that treats all shareholders equally as an any-or-all bid even if part or all of the consideration involves securities of the bidder. We are interested in cases that force shareholders to choose between a partial or a two-tier tender offer, on the one hand, and a uniform-bid tender offer or merger that does not involve pro-rationing, on the other hand. Therefore, we identify those cases in which partial or two-tier offers are subscribed to by target shareholders despite the availability of a more lucrative uniform-bid merger proposal or any-or-all tender offer.

Table 9 highlights such cases by the indication of a "No" response to the column (4) question "Winner Was Any-or-All?", and a "No" response to the column (5) question "Offer with Highest Value Won?" Of the 16 targets that received at least one any-or-all offer, the any-or-all bid loses to a competing partial or two-tier tender offer in only four cases. In three of these cases, it is clear that the rejected any-or-all bid provided less overall compensation to target shareholders than did the competing tender offer. In the remaining case (Conoco), what appears to be the best offer (Mobil's any-or-all bid) was rendered ineffective by the Justice Department's preliminary injunction. Therefore, the any-or-all offer did not have to be topped by the competing bidders.

This investigation of control contests occurring between 1981 and 1983 produces no case supporting the hypothesis that a two-tier or partial tender offer, because of its potentially coercive nature, can dominate a competing any-or-all tender offer or merger bid without offering greater overall compensation. The evidence is that: (i) 12 of 16 head-to-head contests between any-or-all and partial of two-tier offers are won by any-or-all bids, (ii) in three of the four exceptions, the partial or two-tier bid clearly offered greater compensation, and (iii) in the remaining case (Conoco), the losing any-or-all bid, although apparently higher-valued, was ineffective because of antitrust opposition.

VI. Conclusion

This study of 148 tender offers between 1981 and 1983 has several noteworthy results. In general, any-or-all offers are more frequent than partial and two-tier offers, with the former accounting for 91 of the total 148 offers. However, the incidence of any-or-all offers is much higher among smaller targets, while partial and two-tier offers predominate among moderate and large targets. This empirical regularity may reflect an underlying economic difference between any-or-all and two-tier or partial offers, with the latter types favored by bidders for relatively large targets. This implies that any regulatory disincentives currently under consideration to partial and two-tier offers may have more important effects for larger takeover targets than smaller targets.

We present detailed comparisons of uniform premiums in any-or-all offers with blended premiums in two-tier and partial offers. The average premium for the 91 any-or-all offers is highest at 53.4 percent relative to the pre-offer market price. (Note that this is for generally smaller targets.) The 32 two-tier offers yield an average blended premium of 55.1 percent, while the 25 pure partial offers yield 31.3 percent. Any-or-all premiums and two-tier blended premiums are very similar in magnitude—72 percent of two-tier premiums exceed 40 percent while 68 percent of any-or-all premiums do so.

The two-tier offer yields an average first-tier premium of 53.5 percent, virtually identical to the average uniform premium for any-or-all offers. The average second-tier premium of 47.1 percent for two-tier offers is less than the first-tier premium, but it is considerably larger than the "implicit" second-tier premium of 18.6 percent afforded by the 25 partial tender offers. Indeed, the average second-tier premium for two-tier offers (47.1 percent) exceeds the average blended premium for pure, partial offers (43.9 percent). Therefore, two-tier "blended" offers are nearly as beneficial to target shareholders as any-or-all offers, and two-tier offers are significantly more beneficial than pure partial offers which have no second-tier purchases by the bidders.

The study also investigates the relative differences between first-tier and second-tier premiums for two-tier and partial tender offers. Nearly three-fourths of the 32 two-tier offers have less than a 20 percent difference between the first and second-tier premiums. In contrast, less than half of the 25 pure partial offers have less than a 20 percent difference between the first- and second-tier premiums. Therefore, while the second tier of a two-tier offer generally provides a lower premium than does the first-tier, the difference in magnitude between the two premiums is not large, especially when compared to pure partial offers. The average first-tier premium is 14.5 percent larger than the second-tier premium for two-tier offers, while it is 28.7 percent larger than the implicit second-tier premium in pure partial offers.

In view of these results, it probably would not be beneficial to adopt regulatory changes which would encourage the use of partial tender offers instead of two-tier offers. The second-tier premium in two-tier offers is on average twice as large as the implicit second-tier value in partial offers. Any substitution of partial offers for two-tier offers would deprive target shareholders of this greater return.

Also, these results suggest that it is problematic whether target shareholders would benefit from regulatory inducements to use any-or-all instead of two-tier offers. First, such a switch increases the returns to target shareholders only modestly, since any-or-all premiums on average exceed the blended premiums for two-tier offers by a relatively small margin. Second, in view of this data it is likely that forcing the use of any-or-all offers will deter some takeovers, especially of larger targets. The losses to target shareholders from such foregone transactions, even if they are few, can outweigh the benefits of higher any-or-all premiums. This conclusion is strengthened by the expectation that shareholders of large targets are the likely losers in deterred transactions and these large transactions account for much of the dollar gains to target shareholders.

Although it is necessary for policymakers to consider carefully the possible deterrence effects of proposed regulatory changes, the data required for the task is not complete. Specifically, this study does not measure the returns to the acquiring firms so we can only speculate about how regulatory changes such as increased minimum offer periods will reduce takeover activity. Since deterrence effects can have important consequences for shareholder welfare, it is a critical consideration. It is our intention to pursue research that will help one understand better the deterrence effects of takeover regulations.

A second caveat to keep in mind is that the study does not (as yet) utilize the market model of finance to purge the data of the effects of general market movements. This adjustment for market-wide movements in stock prices is especially needed in the computation of the second-tier premiums, which equal the percentage change of the stock price twenty days after the close of the first-tier offer relative to the market price of

the target twenty days before the first offer. These two prices are separated by a few months, during which time the changes in the general level of stock prices could cause these two prices to change significantly. Ignoring the adjustment for general market movements should not greatly affect the overall averages, but it can make important differences in certain cases. Therefore, we are currently in the process of statistically adjusting the value of the second-tier premiums to abstract from general market movements.

A final caveat is that the sample includes only 1981, 1982 and 1983 tender offers. It is desirable to enlarge this sample by including offers over a longer period of time. Future research will incorporate tender offers from the 1970s as well as 1980.

TABLE 1.—NUMBER OF TENDER OFFERS, BY TYPE AND YEAR, 1981–83

[Type of tender offer]

Year	Any-or-all[1]	Two-tier	Pure partial[2]
1981	37	10	10
1982	28	15	7
1983	26	8	8
Total	91	33	25

[1] Any-or-all offers are the all tendered shares, as long as minimum conditions are met.

[2] In two-tier offers, the offer for shares is in two steps. In an explicit two-tier offer, the bidding firm agrees at the time of the initial offer with target management to purchase the remaining shares following the execution of the first-tier partial offer. In implicit two-tier offers, a second tier is announced shortly after the execution of the tender offer.

[3] Pure partial offers are for less than all shares. There is no planned merger or tender offer directly following the execution of the tender offer.

Source: *Tender Offer Statistics, 1981–1983*, Douglas Austin & Associates Inc., 1984 and the *Wall Street Journal*.

TABLE 2.—AVERAGE SIZE[1] OF TARGETS, BY TYPE OF TENDER OFFER AND YEAR, 1981–83

[Type of tender offer—in millions of dollars]

Year	Any-or-all	Two-tier	Pure partial
1981	555.6	660.4	217.2
1982	97.5	291.2	113.0
1983	160.2	284.2	182.5
Total	210.7	451.0	203.0

[1] Size is measured as the market value of target's equity 5 b, computed as the number of fully diluted common shares outstanding by the pre-offer market price of these shares.

TABLE 3A.—ABSOLUTE DISTRIBUTION OF TARGET SIZE, BY TYPE OF TENDER OFFER, 1981–83

[Type of tender offer]

Range of target size (in dollars)	Any-or-all	Two-tier	Pure partial
Less than $5m	10	0	0
$5m to $10m	11	1	0
$10m to $25m	9	1	1
$25m to $50m	18	2	1
$50m to $75m	11	0	0
$75m to $100m	11	0	0
$100m to $200m	15	4	0
Greater than $200m	6	10	0
Total	91	33	25

TABLE 3B.—RELATIVE DISTRIBUTION OF TARGET SIZE, BY TYPE OF TENDER OFFER, 1981–83

[Type of tender offer—in percentages]

Range of target size (in dollars)	Any-or-all	Two-tier	Pure partial
Less than $5m	11.0	3.0	4.0
$5m to $10m	12.1	3.1	0.0
$10m to $25m	9.9	3.1	24.0
$25m to $50m	17.6	6.0	4.0
$50m to $75m	12.2	21.0	24.0
$75m to $100m	12.1	6.2	12.0
$100m to $200m	16.4	30.1	8.0
Greater than $200m	6.6	21.2	20.0
Total	100.0	100.0	100.0

TABLE 3C.—PERCENTAGE OF TENDER OFFERS ACCOUNTED FOR BY EACH TYPE OF OFFER, BY TARGET SIZE, 1981–83

[Type of tender offer]

Range of target size (in dollars)	Any-or-all	Two-tier	Pure partial
Less than $5m	52.6	9.0	7.2
$5m to $10m	78.6	7.2	14.2
$10m to $25m	62.2	8.2	27.6
$25m to $50m	64.2	10.5	6.3
$50m to $75m	42.9	39.2	20.0
$75m to $100m	52.6	15.0	16.7
$100m to $200m	58.8	26.0	6.0
Greater than $200m	26.6	53.0	20.0

TABLE 4.—AVERAGE PERCENT PREMIUMS FOR ANY-OR-ALL OFFERS,[1] AND PERCENT BLENDED PREMIUMS FOR TWO-TIER AND PARTIAL OFFERS,[2] BY YEAR, 1981–83

[Type of tender offer]

Year	Any-or-all	Two-tier	Pure partial
1981	49.8	38.4	36.4
1982	70.7	47.2	37.5
1983	69.6	69.4	48.4
Total	69.4	48.1	41.3

[1] The any-or-all offer premium equals $P_{AO} = (P_1 - P_0)/P_0$.

[2] The blended offer premium equals $P_{BO} = (P_1 + T_2) \div (1 - P_0) - T_2$.

TABLE 5A.—ABSOLUTE DISTRIBUTION OF ANY-OR-ALL PREMIUMS AND BLENDED PREMIUMS, BY TYPE, 1981–83

[Type of tender offer]

Range of percent premium	Any-or-all	Two-tier	Pure partial
Less than 0	0	1	0
0 to 20	10	0	0
20 to 40	21	10	7
40 to 60	15	0	4
60 to 80	10	0	1
80 to 100	6	0	1
100 to 120	7	1	0
Greater than 120	11	1	0
Total	91	33	25

TABLE 5B.—RELATIVE DISTRIBUTION OF PREMIUMS AND BLENDED PREMIUMS, BY TYPE OF TENDER OFFER, 1981–83

[Type of tender offer—in percentages]

Range of percent premium	Any-or-all	Two-tier	Pure partial
Less than 0	0.3	3.1	0.0
0 to 20	10.0	0.0	0.0
20 to 40	10.1	14.0	28.0
40 to 60	20.1	40.0	16.0
60 to 80	17.6	10.0	4.0
80 to 100	10.0	0.0	4.0
100 to 120	0.0	0	0.0
Greater than 120	7.7	3.1	0.0
Total	100	100	100

TABLE 6.—AVERAGE PERCENT BID PREMIUMS[1], BY TYPE AND YEAR, 1981–83

[Type of tender offer]

Year	Any-or-all	Two-tier	Pure partial
1981	66.6	69.0	66.2
1982	70.7	51.6	73.6
1983	69.6	73.2	51.5
Total	69.4	66.6	63.0

[1] The bid premium is the overall premium in any-or-all offers and the first-tier premium in two-tier and pure partial offers.

TABLE 7.—FIRST- AND SECOND-TIER PREMIUMS IN TWO-TIER AND PURE PARTIAL OFFERS, 1981–83

Year	Two-tier			Pure partial		
	First tier	Second tier	Blended offer premium	First tier	Second tier	Blended offer premium
1981	69.0	41.6	55.4	32.2	0.5	16.4
1982	51.0	43.4	47.2	73.6	33.3	37.5
1983	73.2	66.4	69.4	51.5	41.5	48.4
Total	66.6	47.1	56.1	46.0	16.6	31.3

TABLE 8.—ABSOLUTE AND RELATIVE FREQUENCIES OF PERCENT DIFFERENCES BETWEEN FIRST- AND SECOND-TIER VALUES,[1] FOR TWO-TIER AND PARTIAL TENDER OFFERS, 1982–1983[2]

Range of percent differences in bids	Absolute frequency		Relative frequency	
	Two-tier	Partial	Two-tier	Partial
Less than 0	1	0	21.0	25.0
0 to 10	10	0	31.3	33.3
10 to 20	0	1	15.0	4.0
20 to 30	2	0	6.2	15.0
30 to 40	1	1	3.1	8.0
40 to 50	0	1	15.0	4.0
50 to 60	0	1	0.0	4.0
60 to 70	1	1	3.1	8.0
70 to 80	0	1	0.0	4.0
80 to 90	0	0	0.0	0.0
90 to 100	0	0	0.0	0.0
Greater than 100	1	0	3.1	0.0
Total	32	25	100	100

[1] The percent difference in bid values equals $(T_1 - T_2)/T_1 \times 100$.

[2] The mean percent difference between first and second tier values is 14.5 percent for two-tier offers and 28.7 percent for pure partial offers.

TABLE 8.—TENDER OFFER AUCTION CONTESTS FOR CONTROL 1981–83

(A) Target	(B) No. of bidders	(C) No. of any-or-all bidders	(D) Winner was any-or-all?	(E) Offer with highest initial value?	(F) Reason if (E) is "No"
Brentwood Health	2	0	Yes	Yes	
Brunswick	2	0	No	Yes	
Buffalo Forge	2	1	Yes	Yes	
Cities Service	2	0	No	No	July 30, 1982, FTC authorized the issuance of a preliminary injunction of Gulf acquisition. Gulf then abandoned its bid.
Conoco	4	1	No	No	In Nov. of 1981 the Justice Dept issued a preliminary injunction against a Mobil Corp. Acquisition of Conoco.
Fisher Scientific Corp.[1]	2	1	No	Yes	
General American Oil	2	1	Yes	Yes	
General Steel Industries[2]	2	1	Yes	Yes	
Gray Drug Stores	2	1	Yes	Yes	
Idaho Industries	2	1	No	Yes	
Interpace	2	1	No	Yes	
Lightolier	2	0	No	Yes	
Manufacturers Bancorp	2	0	No	Yes	
Marathon	2	0	No	Yes	
Mesa Services, Inc.	2	0	No	Yes	
Natomas Idho Sandia	2	0	No	Yes	
Norton Simon	2	0	No	Yes	
Pabst	4	0	No	Yes	
Property Investors of Colorado	2	1	Yes	Yes	
Richardson	2	1	Yes	Yes	
Standard Cosmos Theater	2	1	Yes	Yes	
St. Joe Minerals	2	1	Yes	Yes	
Stanley Van Corp	2	1	Yes	Yes	
Sunbeam	2	0	No	Yes	
Texas Gas Resources	2	1	Yes	Yes	
Union Commerce	2	1	Yes	[3]	

[1] This is nominally a contest, in April of 1981 a merger proposal was turned down by management. This offer was never made to shareholders. Then in July, when the first offer was long gone, a successful partial tender offer was launched by another firm. The partial offer won, however, it was clearly the better offer.

[2] This is another case where an any-or-all beats a partial. However, it should be pointed out that the partial bid ran into legal problems because of prior open market purchases.

[3] In this case Control Bancorp had the highest per share price on its partial offer. However, it lost to Huntington Bancshares any-or-all offer when the Federal Reserve blocked Control's bid. Since we don't know what Control Bancorp's response would have been, and since the offers were otherwise close, it is difficult to determine whether the best offer won.

[FR Doc. 84-17789 Filed 6-28-84; 8:45 am]

BILLING CODE 8010-01-M

RESPONSE TO QUESTIONS OF SENATOR HEINZ,
HEARING OF APRIL 4, 1985

Chairman Shad, I want to ask you a few questions about the SEC's recent, unprecedented decision to intervene in a state court proceeding on a matter of state law. As I understand it, the SEC has filed an amicus brief with the Delaware Supreme Court on the side of the appellant in the Household International case. I have serious concerns about the SEC's action on both procedural and substantive grounds:

Question 1. It appears that all parties, including those SEC commissioners who voted to intervene, concede that the issue before the Delaware court is solely one of Delaware state law. From a procedural viewpoint, and with an eye toward this country's tradition and policy in support of separate federal and state judicial systems, how can the SEC justify this intrusion into what is clearly a matter of state law to be determined by a state court?

Answer. Although the ultimate issue in the Household International case is one of state law -- whether the adoption by Household's board of a "poison pill" plan was an appropriate exercise of the board's power under Delaware's business judgment rule -- that issue involves underlying matters that have long been of concern to the Commission in regulating takeover contests. The Commission felt that the Delaware court would benefit from hearing the Commission's views, based on its extensive experience in this area, as to those matters.

The trial court held that under Delaware law the plan was a proper exercise of business judgment by the Household board since, in the court's view, the plan would only block certain "coercive" hostile tender offers, and thus

would be in the shareholders' interest. The Commission did not attempt in its brief to suggest what the appropriate legal standard should be under Delaware law, nor take issue with the legal standard applied by the trial court. Rather, the Commission's brief takes issue with the trial court's determination as to the effect of the Household plan. It is the Commission's view that the plan would not merely block allegedly coercive offers, but would in fact block virtually all hostile tender offers for Household, would likely diminish the number of offers that might be made for Household in the first place, and would limit the ability of shareholders to wage proxy contests against management.

The Commission further expressed the view that a plan with such effects is not in the best interests of Household's shareholders. A major principle underlying the Williams Act is that there should be a balance between bidders and management, so that neither unduly influences the tender offer process and that the decision whether to accept or reject an offer is left to the shareholders. The Household plan, by taking the decision as to whether tender offers should succeed from the shareholders and vesting it solely in management, runs counter to this principle.

Thus, while the Household International case does not directly involve federal law, it does involve issues and principles that have been of concern to Congress and the Commission in regulating tender offers. The Commission, as a result of over fifteen years experience in administering the Williams Act, has informed views of where shareholder interests lie in this area. The Commission believed that the Delaware Supreme Court should be aware of these views and that it would be useful to the court to have the Commission's views before it in resolving this case.

With respect to appearing in state court, while the Commission usually appears in federal court, it has on occasion appeared in state court. For instance, the Commission has in the past appeared in state courts, including the Delaware Supreme Court, to challenge the constitutionality of state tender offer statutes.

Question 2. Substantively, given that the SEC has decided to involve itself in a state matter, several commentators, including one SEC commissioner, have concluded that the lower Delaware court's decision was correct under Delaware's business judgment rule. How do you respond?

Answer. The trial court held that the plan was a proper exercise of the Household board's business judgment because it would only block "coercive" hostile tender offers, and thus was in the shareholders' interests. It is the Commission's view that lower court's holding was based on an incorrect premise, namely, that the plan would only block certain types of "coercive" offers. As noted above, the Commission believes that the plan would block all hostile tender offers for Household, would diminish the number of offers made for Household, and would limit proxy contests by shareholders opposed to management. The Commission is of the view that a plan with such effects is not in the Household shareholders' interests, and thus is not a proper exercise of the Household board's power. The Commission's brief expressed the view that, had the trial court not erred in judging the effects of the plan, it too might have concluded that the plan was not in the shareholders' interests, and not justified.

Question 3. You are no doubt aware that a significant number of companies have adopted plans similar to that being challenged in the Household case. Are you aware that several takeover bidders are citing the SEC's action as an expression of SEC support for their takeover attempts? Doesn't the SEC's action contravene the policy of neutrality in the area of takeovers which is and has been the explicit position of both the SEC and the Administration?

Answer. The Commission's brief should not in any sense be read as pro-bidder, or as supporting any particular takeover bids. The Commission's view is that it is for the shareholders, based on full disclosure by bidders and management, to make the decision whether to accept or reject a tender offer. The Commission's neutrality as to the outcome of tender offer contests, however, does not mean that it has no role to play in regulating the tender offer process. The Williams Act, and the rules promulgated thereunder, are expressly designed to assure a balance between bidders and management, for the ultimate purpose of allowing the shareholders to make an informed decision as to whether or not to tender. For example, the statute and rules require that tender offers remain open for twenty days, to allow shareholders sufficient time to make a decision, but allow offers to be closed thereafter, so as to preclude management from having excessive time to defeat an offer.

Maintenance of a balance between bidders and management, and the preservation of shareholder decision-making, is a fundamental objective of the Commission's administration of the Williams Act. The Commission has on numerous occasions, including twice before the Supreme Court, appeared as amicus curiae to challenge state laws that would expand the time available to management to defeat tender offers. The Commission expressed the view in those cases that such state statutes frustrated the balance between management and bidders contemplated by the timetables under the Williams Act.

The policy of evenhandedness espoused by the Commission thus is not a policy mandating a hands-off regulatory approach. Where appropriate, the Commission may be warranted in taking action to maintain an overall balance between bidders and management. In Household International the Commission has expressed the view that the poison pill plan gives management such an extreme degree of control over the tender offer process, that protection of the shareholders' interests requires that it be struck down.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

OFFICE OF
THE CHAIRMAN

July 31, 1985

Th Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
SD-534, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman D'Amato:

The attached SEC staff memorandum responds for the record to a question which you asked during the Subcommittee's hearing of April 4, 1985.

Sincerely,

John S.R. Shad

By Linda C. Quinn

Enclosure

Memorandum

July 24, 1985

TO : Peter Kiernan, Legislative Counsel
Office of Legislative Affairs

FROM : Joseph G. Connolly Jr., Chief
Office of Tender Offers
Division of Corporation Finance

RE : Congressional Hearing Related Request

SUBJECT: Number of Issuers that have (a) adopted "poison pill" security plans and (b) proposed for adoption "anti-greenmail" charter provisions.

At the April 4, 1985, Senate Subcommittee on Securities hearings on Tender Offers, the Chairman was requested to provide the Subcommittee with the number of issuers that have adopted "poison pill" security plans and the number of issuers that have proposed for adoption "anti-greenmail" charter provisions. Set forth below is the information requested for fiscal year 1985.

"Poison Pill" Security Plans

AMF
Amsted
ASARCO
Burroughs Corp.
Colgate Palmolive Co.
Electronic Systems Tech
Excel Industries
General Host Corp.
Great Lakes International
Jerrico Inc.
Johnson Controls
Michigan National Corp.
Morton-Thiokol
Phillips Petroleum
Rorer Group
Southwest Forest Industries
Unocal
Wainoco Oil

Anti-Greenmail Provisions

Aluminum Co. of America
American President Co.
Anheuser Busch Co.
Apache Corp.
Argo Petroleum Corp.
Atlantic Richfield
Avery International
Bausch and Lomb Inc.
Chesebrough Ponds
Cole Laboratories
Cordura Corp.
Cross and Trecker Corp.
Diamond Shamrock
Dover Corp.
Dresser Industries
Eastern Gas and Fuel
Endevco Inc.
Fay's Drug
Fleming Companies
Franklin Bancorp.
Fuqua Industries
B.F. Goodrich
Gould Inc.
Heck's Inc.
Informatics General
Interco Inc.
KDI Corp.
Kaneb Services Inc.
Kerr-McGee Corp.
Lubrizol Corp.
Lufkin Corp.
Martin Marietta
Mobil Corp.
NCR Corp.
NWA Inc.
Owens and Minor Inc.
Pacific Gamble Robinson
Shoney's South Inc.
Singer Company
Sterling Drug
Thomas and Betts Corp.
WARNACO

Senator D'AMATO. Our next witness is Preston Martin, Vice Chairman of the Federal Reserve Board.

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MARTIN. Buon giorno, Mr. Chairman.

Senator D'AMATO. Buon giorno to you, Mr. Martin. Good to see you, Preston.

Mr. MARTIN. I'm pleased to appear before the committee. I will request that my statement be placed in the record in its entirety and——

Senator D'AMATO. So ordered.

Mr. MARTIN. In the interest of mercy we'll truncate my statement, Mr. Chairman, and Senator Proxmire.

MAGNITUDE OF RECENT MERGERS

The magnitude of recent merger trends underscores the importance of assessing the implications of this activity. The number of completed merger transactions in 1984 totaled more than 2,800. Although more firms reportedly were involved in merger activity in the late 1960's, the dollar size of recent transactions exceed by a wide margin any past experience.

Last year there were 14 merger transactions that came to our attention that exceeded $1 billion each and these alone accounted for more than $50 billion in activity.

Nonfinancial corporations as a whole retired an estimated $85 billion of equity through mergers, takeovers, and share repurchases. Included in this total is about $15 billion of equity retired through so-called leveraged buyouts.

We are all aware that a large portion of these merger transactions has been financed with debt including short-term commercial bank debt. Leveraged buyouts typically entail as much as 80 to 90 percent debt financing. I won't take the committee's time; you've had good testimony on the structure of those transactions.

In my view, there is a legitimate place in our economy for mergers and takeovers, even unfriendly takeovers in some instances. They can be important mechanisms for redeploying corporate assets to their most profitable and maybe socially beneficial uses, and they can bring about better management.

But we must be careful about imposing the judgment of governmental authorities concerning which private transactions will be economically productive; that isn't the thrust of these hearings at any rate. However, the Government must take steps to ensure that individual risktaking does not jeopardize the stability of our financial system. As I will discuss later, the Federal Reserve recognizes its responsibilities in this area.

Our concerns have focused on the effect that merger and takeover activity may have on aggregate credit flows and on the risk exposure of financial institutions and markets. With respect to credit flows, estimates by our staff indicate that growth in the domestic nonfinancial debt aggregate, which is one of the aggregates we monitor in the course of monetary policy deliberations, was boosted

by 1 to 1½ percentage points in 1984 as a result of merger-related borrowing.

But mergers and buyouts appear likely to have had a much more limited impact on the three monetary aggregates for which we establish actual target ranges. And the least impact, apparently, is on M1, the narrow transactions aggregate.

Moreover, the Board is aware of the merger, buyout, and acquisition activity and takes this into consideration when evaluating the behavior of the money and debt aggregates. Given our ability to monitor the size and timing of the very large transactions, we feel we can anticipate possible distortions in the aggregates for a particular period and thus avoid inadvertently reacting to these factors in policy deliberations. In sum, I don't believe mergers present a real operational problem for us that would result in appreciable unintended variations in reserve market pressures.

More fundamental determinants of credit demand, which have been reviewed here, including the behavior of the household sector, capital expenditures of business and, of course, the fiscal position of the Federal Government, all exert much more powerful and persistent pressures on credit markets than does takeover activity.

Some members of the public and of Congress have expressed concerns that merger activity absorbs credit that could be used to support other, perhaps, more productive, perhaps more socially desirable purposes. But this would be true only in unusual circumstances and for temporary periods. Basically, merger and acquisition transactions involve transfers of ownership of existing assets and do not absorb net real savings in the economy. Proceeds from the transactions either return to bank accounts or are reinvested in other financial instruments, thereby, recycling the funds into the market. With today's high real interest rates, these funds just don't lie around.

The more pertinent consideration regarding merger financing from our point of view, is the potential for greater risk exposure of the financial system. Because many mergers and leveraged buyouts have involved heavy reliance on debt coupled with retirement of existing equity, the surviving firms are more vulnerable to downturns in earnings or sharp increases in interest rates. And, as the committee knows, we have not been through a recession period of substance since the great volume of leverage buyouts, mergers, acquisitions, takeovers, and so forth have occurred.

Now, when these negative circumstances take place, it means that the institutions providing the credit may, in turn, be more exposed to possible loss. Leveraged buyouts may be a particular concern because they typically involve larger proportions of debt and smaller amounts of equities.

The Federal Reserve has actively urged banks to evaluate carefully loans used to finance buyouts and other types of takeover transactions and to apply prudent standards in their credit decisions. We have instructions out to our examiners in that concern.

DEBT/EQUITY PROBLEM

Senator D'AMATO. Preston, you have just put your finger on one of the key issues, the question of whether or not corporate America

is becoming too highly leveraged. Along with this trend toward higher debt/equity ratios we have to consider the possible shakeout of corporations that could occur with the first economic downturn and what the impact would be on our depository institutions that provided the financing for these business combinations. Clearly there is a potential for serious problems with banks that have participated too heavily in financing leveraged buyouts.

Mr. MARTIN. Yes, sir.

Senator D'AMATO. What can you do to stay ahead of this problem?

Mr. MARTIN. I think what we can do is to continue our training of our examiners, and in that training alert the examiner staffs as to the risks. They must make sure that the projections that are so often the basis for the buyout or the acquisition are well founded.

The simulations by management may not always take into consideration the worst case, but will project flat interest rates, for example, and will project earnings going up more than would be anticipated. There's a 6-percent syndrome we have found in making these examinations, almost regardless of how quiescent an industry is involved. The takeover firm's management projects a 6-percent growth in earnings, at compound interest, so earnings double every 12 years. Well, is 6 percent reasonable here? Or should it be 2 percent or whatever? So I think we've got to test and test and test when we go into these portfolios.

Senator D'AMATO. Some people have raised the question—I think in yesterday's panel some of the business interests raised the question—as to whether or not the banks, were ready to make this line of credit available and earn a commitment fee almost on the hope that they wouldn't have to come up with the money with the commitment fee being the real incentive.

Mr. MARTIN. That's quite accurate. As we all know, the banking industry now—commercial banking industry now—is in a milieu in which spread management is getting to be not impossible but very, very difficult and if you add to that the pressures by the Federal Reserve and the other regulatory agencies for augmentation of capital, then you have the search for off-balance sheet, if you will, off-income statement—that's an exaggeration—new sources of income. And, of course, fee income of all sorts is one solution to that.

Senator D'AMATO. Is there anything being done, Mr. Chairman, in regard to that, to examine this area to determine whether banks are making commitments for unsound merger proposals.

Mr. MARTIN. Well, we have specific language in our written instructions to our examiners which address that problem. Has this credit—is this credit carrying a market rate? Does this credit look as though there is reaching for market share at the expense of quality of assets or other credit considerations, Mr. Examiner? You know that is part of the thing you have to check when you get into this portfolio.

Senator D'AMATO. Excuse me for the interruption but I thought that at that point in time you really hit the area that we're concerned about.

Mr. MARTIN. Yes, sir.

Well, continuing then, we have expressed our concerns, we'll continue to express our concerns in speeches, in meetings, in counsel-

ing sessions, in addition to the examination process. And there we are stressing the potential hazards of mergers and leveraged buyouts, the concentration of lending which can result from a kind of adding on of these mergers and acquisition financings to the normal lending program.

BANKERS REVIEWING LENDING PRACTICES

Members of the banking community have indicated to us that they are reviewing lending practices to ensure that prudent standards are applied to potential credit extensions and takeovers. It's very difficult to sort out what's been going on. It's a very competitive market; these are very big institutions. But we continue to use that kind of a moral persuasion, if you will.

Reportedly, a number of attempted buyouts have been terminated as a result of difficulties encountered in obtaining needed financing, which suggests some more selectivity on the part of lenders. I think some of this is going on.

We hope that prudent lending standards will be applied by lenders including the lenders against so-called junk bonds. The large investors who purchase most of these bonds are relatively sophisticated but I'm not sure, in this market, what that means. They should be aware of the risks involved. Of course, that's what you have rating services for and that's why companies take the time and expense to get their securities rated.

But it would be fair to say that one cannot really be comfortable about the assumptions I've mentioned, especially when the market hasn't been tested by significantly negative economic developments and negative surprises will inevitably come. The higher rates paid on the low-rated or unrated bonds suggest that they are perceived in the market to involve greater risks. The question is whether the risk premiums will, in fact, prove to be adequate.

Lending to finance mergers and acquisitions need not weaken the financial fabric, however. Although the companies that have been created out of this surge are relatively untested, we have not seen to date significant data showing that problems for financial markets or for the financial system arise out of this activity. There's no significant information in that way.

In part, this may reflect the favorable economic and financial environment of the current expansion. After all, these transactions in many cases have occurred in this expansion. While some individual firms have taken on greater leverage, other businesses have taken advantage of improved conditions to strengthen their balance sheets.

And, finally, to the extent that divestment results in smaller organizations, there is an argument that's been reviewed here that motivated management could increase the profitability, the viability of the firm. I've managed under both conditions and I must say I have managed small and I have managed large, and small is better. But I can't generalize much further than that.

We do not believe that arbitrary controls on the uses of credit can be effective or desirable nor can a Government agency determine among thousands of mergers which are good and which are bad. A given transaction may be desirable from a social and eco-

nomic standpoint if it results in the economies of scale or if it results in small scale and more efficient operation. Or if it results in better management or a more efficient allocation of resources. However, attempts to regulate flows of credit for particular purposes run the risk of creating unintended distortions in credit flows and impeding the efficient allocation of capital.

I do not wish to imply, however, that we should be complacent about the implications for the financial system of lending for mergers and takeovers. The Federal Reserve will continue to monitor this activity, and to measure the effects on financial markets of the merger surge. And our examination standards, I've already mentioned, are still under review.

Congress and other governmental agencies need to give close scrutiny to the numerous offensive and defensive practices. They have been reviewed here today and elsewhere. And the allusion has been made to reviewing features in the tax system which appear to encourage merger activity.

So I think, Mr. Chairman, in sum, we don't believe that this activity is giving us problems in the implementation of monetary policy. We are attempting to do everything we can to be alert and to monitor the possible risks in the quality of assets of the lending institutions, and we think this hearing is very appropriate and timely.

[The complete prepared statement follows:]

Statement

by

Preston Martin

Vice Chairman

Board of Governors of the Federal Reserve System

I am pleased to appear before this committee to discuss the recent surge in merger and takeover activity and the potential effect of this activity on credit market conditions.

The magnitude of recent merger trends underscores the importance of assessing the implications of this activity, as you are reviewing in these hearings. The number of completed merger transactions in 1984 totaled more than 2,800; and it seems that almost every day we read in the press of a new combination of firms or a threatened takeover. These figures may not be unprecedented; in the late years of the 1960s, for example, more firms reportedly were involved in merger activity (attachment 1). But the dollar size of recent transactions exceeds by a wide margin any past experience. The largest acquisition in 1984 totaled $13.3 billion, nearly twice as large as any single merger of previous years. Indeed, last year there were 14 merger transactions that exceeded $1 billion each (attachment 2). These 14 combinations alone accounted for more than $50 billion in activity.

Many more smaller transactions bolstered the total dollar volume of acquisition activity to record levels last year; during 1984, nonfinancial corporations retired an estimated $85 billion of equity through mergers, takeovers, and share repurchases. Included in this total is about $15 billion of equity retired through so-called leveraged buyouts, which rely heavily on debt financing. In a typical leveraged buyout, an individual or small group of investors and/or management purchases a company or subsidiary of a company with the proceeds of loans collateralized by the assets of the company, and then takes the company private.

In my view, there is a legitimate place in our economy for mergers and takeovers. They can be important mechanisms for redeploying corporate assets to their most profitable--and socially beneficial--uses, and for bringing about better management. We must be careful about attempting to impose the judgment of governmental authorities about which among thousands of private transactions will be economically productive and which will not; in most instances the parties whose fortunes are at stake are likely to be better judges. Governmental authorities are obliged to do what they can to ensure that individual risk-taking does not jeopardize the stability of our financial system. As I will discuss below, the Federal Reserve recognizes its responsibilities in this area.

Assessing the implications of merger activity is complex. From the perspective of the Federal Reserve, concerns have focused on the effect that this activity is likely to have on aggregate credit flows and on the risk exposure of financial institutions and markets. We all are aware that a large portion of these merger transactions has been financed, at least initially, with debt, including short-term bank credit. Leveraged buyouts typically entail as much as 80 to 90 percent debt financing; and among the largest mergers last year, credit sources initially financed about 75 to 80 percent of the equity purchases.

Estimates by Board staff indicate that growth in the domestic nonfinancial debt aggregate--which is one of the aggregates that the Federal Reserve monitors in the course of its monetary policy deliberations--was

boosted by about 1 to 1-1/2 percentage points in 1984 as a result of merger-related borrowings. Mergers and buyouts appear likely to have had a much more limited impact on the narrow money aggregate, M1. The checking accounts of merger participants may be increased temporarily as a result of the mergers, but proceeds from merger sales are generally reinvested in other assets, so that the effect on M1 tends to be insignificant over periods of time relevant for monetary policy deliberations. The broader aggregates, M2 and M3, may be boosted somewhat more than M1, as some proceeds from stock sales find their way into time deposits, money market mutual funds, or other assets that are included in these aggregates. But relative to the large size of M2 and M3 this effect also would be relatively minor.

The Board is aware of the influence of merger activity and takes it into consideration when evaluating the behavior of the money and debt aggregates. Given our ability to monitor the size and timing of very large transactions, we can anticipate possible distortions to the aggregates in a particular period and thus avoid inadvertly reacting to these factors in policy deliberations. Moreover, distortions in the credit aggregate, where the potential problems are largest, are less likely to mislead policy deliberations. In setting monitoring ranges for this aggregate, the FOMC recognizes that numerous factors, including merger activity, may alter the behavior of credit growth relative to GNP. Thus, I don't believe mergers present a real operational problem for us that would result in appreciable unintended variations in reserve market pressures. More fundamental determinants of credit demand, including the behavior of the household sector,

capital expenditures of businesses, and, of course, the fiscal position of the federal government, exert much more powerful and persistent pressures on credit markets than does takeover activity.

Some members of the public and Congress have expressed concerns that merger activity absorbs credit that could be used to support other, perhaps more productive, purposes. But this would be true only in unusual circumstances and for temporary periods. Basically, merger and acquisition transactions involve transfers of ownership of existing assets and do not absorb net real savings in the economy. Proceeds from the transactions either are returned to bank accounts or reinvested in other financial instruments, thereby recycling the funds into the markets. Thus, these transactions should not generate significant lasting reductions in the amounts of financial resources available to other borrowers.

However, mergers may alter the cost or amount of credit available to some borrowers if banks that extend large amounts of takeover credit are subject to capital or liquidity constraints and reduce their lending to other potential borrowers for a time. In this case, those borrowers with limited access to financial markets would be vulnerable to the potential effects of these transactions. However, in the case of many mergers, corporations have begun to repay loans, frequently within a month or so after the takeover, with funds raised through sales of assets or new equity, or by borrowing in the commercial paper or bond markets. More than two-thirds of the $32 billion of bank loans extended to finance the largest

mergers last year has been repaid (attachment 3); the bulk of these repayments occurred within 6 months of the loan extensions. A number of foreign banks also have participated in the financing arrangements of many of the larger mergers, thus expanding the supply of funds in domestic markets. Among the largest transactions completed last year, approximately $7 billion, about one-fifth of the intitial bank financing reportly came from foreign banks (attachment 3). Foreign banks have also purchased merger loans originally made at large U.S. banks, though we have no statistics on the total volume of this activity.

A more pertinent consideration regarding merger financing from the Federal Reserve's perspective is the potential for greater risk exposure of the financial system. The Board of Governors, as bank and bank holding company supervisor and lender of last resort, has responsibility along with the other regulatory agencies for maintaining the safety and soundness of financial institutions and markets. In this regard, we are especially concerned about potential financial risks involved with leveraging and with acquisition activity financed with large amounts of debt. Because many mergers and leveraged buyouts have involved heavy reliance on debt and retirement of existing equity, the surviving firms have had balance sheets that leave them more vulnerable to downturns in earnings or sharp increases in interest rates. When this occurs, it of course means that the institutions providing the credit may in turn be more exposed to possible loss.

Leveraged buyouts may be of particular concern because these purchases are typically executed using larger proportions of debt and smaller amounts of equity than mergers. In 1984, leveraged buyout deals involving U.S. companies are estimated to have amounted to over $15 billion, with buyers rarely putting up more than 10 percent of the purchase price. The ability of the firm to service this debt burden depends on the value of the assets and on the company's future earnings and cash flow prospects. These factors may be particularly difficult to evaluate for buyouts, if past operations are not expected to be a guide to future profitability--which is, after all, the economic rationale of many buyouts. Because buyout loans usually involve floating rate debt, the companies would be particularly vulnerable in the event that interest rates rise substantially and cash flows are not adequate to service heavy debt burdens. But prudent lending practices established by lenders take these possible outcomes into consideration, and thus help to insure that any failures associated with heavy leveraging would be only isolated events.

The Federal Reserve has actively urged banks to evaluate carefully loans used to finance buyouts and other types of takeover transactions and to apply prudent standards in their credit decisions. Bank examiners have been instructed to review banks' involvement with leveraged buyout financing, and we have issued specific guidelines for the examiners to follow in evaluating loans used for this purpose, and for assessing the total exposure of a bank to such lending. A policy directive issued in 1984 to examiners at each

of the 12 District Federal Reserve Banks by the Director of the Board's Division of Banking Supervision and Regulation pointed out that the high volume of debt relative to equity that is characteristic of leveraged buyouts reduces the cushion available to the purchased company to withstand unanticipated financial pressures or economic adversity (attachment 4).

The Board policy directive noted the following two financial risks associated with leveraged buyout financing: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy.

The Board directive stated that, given the amount of debt involved in leveraged buyouts, the value of collateral should be emphasized in order to protect the creditworthiness of these loans. The quality of a purchased company's management is also important and represents another element in the bank's evaluation of leveraged buyouts. This is because management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.

The Board of Governors has expressed its concerns about the potential hazards of mergers and leveraged buyouts with leaders of the banking community through public statements and informal discussions. Members of

the banking community have indicated that they are reviewing lending practices to ensure that prudent standards are applied to potential credit extensions for takeovers. Reportedly a number of attempted buyouts have been terminated as a result of difficulties encountered in obtaining needed financing. At least $3 billion of proposed leveraged buyouts were abandoned last year because financing was not available, and we have read in the press recently of two or three sizable buyouts that were terminated for this reason. These reports suggest some selectivity on the part of lenders.

We hope that prudent lending standards will be applied by all lenders, including purchasers of so-called "junk bonds". Junk bonds are low-rated or unrated bond issues, which seem to have gained popularity as a tool for financing mergers and takeover attempts. The large investors who purchase most of these bonds are relatively sophisticated and should be aware of the risks involved. But it would be fair to say that one cannot really be entirely comfortable about such assumptions, especially when the market has not been tested by some significant negative surprises--which inevitably will come at some point. The higher rates paid on the junk bonds suggest that they are perceived by the market to involve greater risks; the question is whether the risk premiums will in fact prove to be adequate.

I should note that, while federally chartered depository institutions may make loans to low-rated borrowers, they are prohibited from acquiring junk bonds in their investment portfolios because they are not

considered to be investment grade securities. But some state-chartered institutions may not be subject to such restrictions, and some state-chartered thrifts have purchased these securities. Given the evident sensitivity of financial markets to the fortunes of individual banks and thrift institutions, I think it is incumbent upon supervisors at both the federal and state levels to keep a close eye on developments in this area.

Lending on a prudent basis to finance mergers and acquisitions need not weaken the financial fabric. Although the companies that have been created out of this recent surge in merger activity are still relatively untested, we have not seen to date significant problems for financial markets arising out of this activity. In part, this may reflect the favorable economic and financial environment of the current expansion. Most sectors have experienced substantial increases in corporate profits and cash flows over the past year and interest rates are appreciably below the levels of the early 1980s. While some indvidual firms have taken on greater leverage, other businesses have taken advantage of improved conditions to strengthen their balance sheets. For the economy as a whole, retirements of equity through mergers and merger-related activity have been partially offset by improvements in the market values of assets and by boosts to equity from retained earnings growing out of the current expansion.

We do not believe that arbitrary controls of uses of credit can be effective or desirable. Nor can a government agency determine among thousands of mergers which are good and which are bad. A given transaction

may be desirable from a social and economic standpoint if it results in economies of scale, better management or a more efficient allocation of resources. A blanket prohibition of all merger financing would be undesirable. Moreover, attempts to regulate flows of credit for particular purposes run the risk of creating unintended distortions in credit flows and impeding the efficient allocation of capital. When credit controls are in existence for any length of time, they become increasingly inequitable as borrowers and lenders seek to circumvent them. Credit controls are usually extremely difficult to enforce: since credit is fungible, most financing can be achieved through alternative channels, such as borrowing through nonregulated intermediaries, foreign lenders, or the like.

I do not wish to imply, however, that we should be complacent about the implications of lending for mergers and takeovers. The Federal Reserve will continue to monitor this activity and its effects on financial markets, and our examination standards in this regard are undergoing further review. And Congress and other governmental agencies need to give close scrutiny to the numerous offensive and defensive practices that have arisen in association with mergers, leveraged buyouts, and hostile takeovers to ensure that institutions and investors are provided adequate protection. Also, a careful review should be given to features of the tax system that appear to encourage merger activity, and in particular those features that favor the use of debt financing.

Attachment 1

MERGER AND ACQUISITIONS OF U.S. CORPORATIONS[1]

	Completed transactions[2]		Announced transactions[3]	
	Number	Dollar volume ($ billions)	Number	Dollar volume ($ billions)
1967	1,800	$15.0	2,975	n.a.
1968	2,440	28.0	4,462	$43.6
1969	3,012	n.a.	6,107	23.7
1970	1,318	n.a.	5,152	16.4
1971	1,269	n.a.	4,608	12.6
1972	1,263	n.a.	4,801	16.7
1973	1,064	n.a.	4,040	16.7
1974	1,088	n.a.	2,861	12.5
1975	859	n.a.	2,297	11.8
1976	1,058	n.a.	2,276	20.0
1977	1,139	n.a.	2,224	21.9
1978	1,364	n.a.	2,106	34.2
1979	1,420	n.a.	2,128	43.5
1980	1,470	34.7	1,889	44.3
1981	2,231	72.4	2,395	82.6
1982	2,182	65.1	2,346	53.8
1983	2,191	50.5	2,533	73.1
1984	2,807	122.0	2,543	122.2

n.a.--not available.

1. Purchases of U.S. corporations by other U.S. companies and by foreign companies. Divestitures or sales of subsidiaries, divisions, or product lines also are included.

2. Data from Mergers and Acquisitions magazine. Includes transactions valued at $1 million or more in cash, market value of capital stock exchanged, or debt securities. Partial acquisitions of 5 percent or more of a company's capital stock are included if the size requirement is met. Data shown for the number of transactions completed in the years 1970-79 exclude divestitures and foreign acquisitions.

3. Data published by W.T. Grimm. Data represent announcement of transactions, some of which were not actually completed. The series records announcements of any transfer of ownership of at least 10 percent of a company's assets or equity. Foreign acquisitions of U.S. companies also are included.

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Attachment 2

LARGEST MERGER AND ACQUISITION TRANSACTIONS OF U.S. COMPANIES[1]

Acquiring company	Acquired company	Total price paid	Initial means of payment to selling stockholders			Subsequent public stock offerings
			Cash	Stock	Debt	
		millions of dollars				
1984						
Chevron	Gulf	13,300	13,300	—	--	—
Texaco	Getty Oil	10,120	10,120	—	--	113
Mobil	Superior Oil	5,700	3,800	—	1,900	—
Royal Dutch/Shell	Shell Oil	4,500	4,500	—	--	—
KMI Continental[2]	Continental Group	2,750	2,750	—	--	—
Beatrice	Esmark	2,725	2,725	—	--	—
General Motors	Electronic Data Sys.	2,500	1,900	600	--	191
Champion Int'l.	St. Regis	1,840	1,000	840	--	—
Dun & Bradstreet	A.C. Nielsen	1,300	—	1,300	--	—
IBM	Rolm	1,260	--	—	1,260	—
PACE Industries[2]	City Investing	1,250	1,250	—	--	—
American Stores	Jewel Cos.	1,150	817	333	--	—
JWK Acquisition[2]	Metromedia	1,130	825	—	305	—
Texas Eastern	Petrolane	1,040	1,040	--	--	--
	TOTAL	50,565	44,027	3,073	3,465	304
1985						
Nestle	Carnation	3,000	3,000	—	--	—
Rockwell International	Allen Bradley	1,650	1,650	--	--	—
Textron	Avco	1,380	1,380	--	--	—
Pending:						
Coastal	Am. Nat. Resources	2,460	2,460	—	--	—
Chesebrough-Ponds	Stauffer Chem.	1,250	1,250	—	--	—
Royal Dutch/Shell	Shell Oil[3]	1,170	1,170	--	--	—
Capital Cities Commu.	ABC	3,500	3,400	100	--	—
Cooper Industries	MC-Graw Edison	1,400	1,400	—	--	—

1. Acquisitions of $1.0 billion and over of shares in U.S. companies. Divestitures are excluded. Data are based on public information.
2. Leveraged buyout.
3. Final portion of Shell shares.

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Attachment 3

LARGE MERGER-RELATED BANK CREDIT DEVELOPMENTS IN 1984

	Total (U.S. and foreign banks)	Estimated U.S. bank participation[1]
	-------billions of dollars------	
Estimated large credit lines arranged for potential acquisitions of U.S. nonfinancial firms in 1984[2]	57.9	35.5
Merger-related loans taken down[3]	31.9	24.9
Memorandum: Total loans outstanding at all banks, December 1984 (excluding interbank loans)	—	1,326.8

1. Includes U.S.-chartered commercial banks, U.S. branches and agencies of foreign banks and foreign branches of U.S. banks where known.
2. Includes credit lines of Texaco, Chevron, ARCO, Mobil, Teledyne, Limited/Carter Hawley Hale, Beatrice Foods, JWK (Metromedia), Champion, American Stores, Texas Eastern, Kiewit-Murdock, Nestle, Houston Natural Gas, Gulf and Western, Textron, Phillips Oil, PACE Industries.
3. Amounts reflect estimated maximums taken down before repayments commenced. Substantial repayments (over two-thirds of the total) were made by borrowing companies using proceeds of borrowings in the commercial paper and bond markets as well as from sale of assets. Three of the credit lines arranged for merger financing were not taken down in 1984.

Attachment 4

GUIDELINES FOR EVALUATING LEVERAGED-BUYOUT LOANS

The Board directive to its bank examiners specified the following examination guidelines to supplement existing loan procedures:

1. In evaluating individual loans and credit files, particular attention should be addressed to i) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through the financing arrangements.

4. The bank's pricing, credit policies and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit, and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examinations report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

Senator D'AMATO. Thank you very much, Mr. Martin. Two quick questions. To your knowledge, what does the Comptroller of the Currency instruct their examiners in regard to the monitoring of the loans for the mergers and acquisitions? Are they as vigilant? Have you spoken to them in regard to this?

Mr. MARTIN. Yes, sir.

STANDARDS ARE SIMILAR TO THE FED

Senator D'AMATO. They've done a poor job as it relates to other areas. Money laundering, et cetera.

Mr. MARTIN. I didn't investigate that, I'll admit, but in terms of the standards with regard to so-called junk bonds, with regard to merger acquisition lending, we and they have very similar, not identical, but very parallel instructions to the examiner staffs.

Senator D'AMATO. And the second question is, you've touched on this. Should federally insured S&L's be permitted to purchase junk bonds?

Mr. MARTIN. Well, we do not, nor does the Comptroller permit the purchase of these low-rated and non-rated risky securities. I would think that this is a far cry from the basic purpose of thrift institutions, which is to facilitate housing and community development. But again, although there are some spectacular incidents cited in the press, it is difficult to make the case that the holding of junk bonds has resulted in this or that impact.

Senator D'AMATO. Well, today, some of these institutions, have been fairly successful.

Mr. MARTIN. They have been successful, in terms of the rates of growth and their augmentation of size; yes.

Senator D'AMATO. Are you concerned about a potential, though, for severe loss to the Federal Deposit Insurance System?

Mr. MARTIN. Very concerned with regard to potential loss, very concerned that there exists in the thrift industry a minority of institutions who are reaching, reaching for income and fee and junk-bond acquisition is a part of this reaching, and it is disturbing.

Senator D'AMATO. Should we take any action in regard to that?

Mr. MARTIN. Well, I would have to defer to the—I am a long since past ex-Chairman of the Federal Home Loan Bank System, Mr. Chairman. I am not up to date as to numbers and so forth. If I were playing a different role, I would say yes, but I am not playing that role, so I don't know, sir.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman Martin, you're an eminent economist, and you've got experience as head of the Home Loan Bank Board, as well as Vice Chairman of the Federal Reserve Board. You are one of our top central bankers. So I would like your observation on what Chairman Shad just told us. He seems to believe that capital is created when the price of a stock increases, and it's increased, obviously, when we have takeover bids or even takeover threats.

I always thought capital was created when a new plant was built or a new product developed. And yesterday we had Martin Lipton, who's been in more takeover fights on both sides—as a takeover

advocate and as a defender—than just about anybody. And he said this, and I quote briefly from him:

> During the past 3 years there has been sharp growth in highly leveraged takeovers by entrepreneurs who are not interested in operating target companies but seek the opportunity for profit through greenmail, bust-up liquidation of the targets, and so forth. These takeovers are not for the purpose of diversification, expansion, or growth, but are financial transactions for the profit of the takeover entrepreneurs. They do not add to the national wealth.

Now who is right? Mr. Lipton, who has been in on all of these, or Mr. Shad, who is Chairman of the SEC and a highly respected expert also? What's your view?

Mr. MARTIN. I think, Senator Proxmire, that I would be more on Mr. Lipton's side, in the sense that as the transactions take place, there are no more factories or no more personal computers, there are no more telecommunications equipment anywhere. I think, however, that the increase in the stock price which is what Chairman Shad referred to might itself stimulate, subsequently, some additional investment in industry X or Y, that the stockholders might use their capital gains, if any, to further some new investment; but I think in the immediate sense, Mr. Lipton is quite correct.

Senator PROXMIRE. Isn't there the experience that companies tend to curtail their research and development, for example, in anticipation of a takeover and to make themselves less attractive takeover targets?

SHORT-TERM FOCUS OF U.S. COMPANIES

Mr. MARTIN. Yes, sir. One of our difficulties in competing with the Japanese, which is a matter of some concern to just about everybody these days, is the short-term, quarter-by-quarter focus of U.S. management. In particular companies, which are up before the securities analysts every quarter, or whatever, must find that this takeover situation tends to put additional pressure on them for short-term results. Raise the dividend rate right now. Don't put funds in R&D. Show some profit in the short run, next quarter, because that will keep our stockholders happy and perhaps that is the answer to our stock price rising, and then we won't have to worry about the raider.

Senator PROXMIRE. On March 12, less than a month ago, Unocal Corp. filed a lawsuit against Security Pacific, one of the biggest banks in the country, alleging among other things, fraud, negligent misrepresentation, breach of contract and breach of fiduciary duty. It turns out that after a relationship of some 40 years, in which Security Pacific continually received confidential financial, geological and engineering information from Unocal, the bank turned around and loaned money to a group intent on taking over Unocal or putting it into play as an acquisition target.

This particular instance aside, I wonder how many other cases there are in which banks are playing both sides of these deals at the same time, and also whether you believe there was any conflict of interest involved in this type of activity.

Mr. MARTIN. Well, to answer your first question, I checked with our examination people, and we're not aware of a whole raft of these "finance the would-be takeover and finance the target compa-

ny" situations; thus, as far as we can tell in a cursory review, it is not a widespread practice.

Senator PROXMIRE. Do you regard this as a conflict of interest?

Mr. MARTIN. On the question of the conflict of interest, it seems to me that the burden of proof has to be on the lender, that there is not a conflict of interest here.

Senator PROXMIRE. They took the confidential information they'd been working with for years, and then turned around and helped the hostile takeover people move in on the corporation with whom they had the confidential relationship.

Mr. MARTIN. Yes, sir, I am being careful, because I don't know from my own knowledge that confidential information was shared with the would-be takeover people. I just don't know.

Senator PROXMIRE. Well, I see. All right.

Let me ask you this: According to a letter I received recently from Chairman Volcker, and I quote the letter,

> The Federal Reserve has actually urged banks to be mindful of the potential risk in evaluating loans for leveraged buyouts, and to ensure that prudent standards are applied. Specific guidelines have been issued for bank examiners to follow in reviewing a bank's involvement in leveraged buyout financing.

Would you explain for the subcomittee the guidelines that have been established and why you found it necessary to establish them?

GUIDELINES TO BANKS

Mr. MARTIN. We found it necessary to establish these guidelines because the very breadth and depth of this kind of financing now involves so many commercial banks and so many commercial bank holding companies for which we're responsible.

We also wanted to alert examiners in every part of the country to the leveraged buyout, to the new kinds of transactions and the kinds of financing asked for and to the phenomenon of the junk bond. Obviously, our examiners working out of the New York area are very familiar with this, and I could cite other metropolitan areas. But it had become such a widespread practice, that we felt it was very necessary to instruct our examiners, specifically, as I responded to the chairman, to test the projections which determine the risks and characteristics of the debt assumed by the bank.

Senator PROXMIRE. In addition to guidelines, what other specific actions has the Fed taken or is it thinking of taking to caution banks in their lending activity for possible takeovers?

Mr. MARTIN. I think that at this time, that would subsume our activities. As we learn more out of the examination process, we may take a different attitude, for example, as to when is it appropriate to go to the board of directors of the bank and make known, as part of our report to that board, the concentration of the bank's portfolio in leveraged bond accounts, et cetera, et cetera. That may be something down the road. It may be that we will find, once the experience in the markets takes place, that the junk bond is so risky as a financial instrument, that more pressure should be placed on management to divest them or that it may be necessary to begin to establish reserve practices.

We might say, for example "you've got 1 million dollars' worth of financing, including the junk bonds, against your total portfolio.

We better take another look at your general reserve position, considering the risk." But those are possibilities down the road and we haven't yet found the evidence to justify those requirements.

Senator PROXMIRE. Thank you, Mr. Chairman.

Senator D'AMATO. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Just one question, Mr. Martin. You touched on it. I'd like to pursue it. With some of our financial institutions that were organized in charter for specific purposes, mainly savings and loans for home loans. And you mention now certain ones who get into junk bonds or maybe higher interest on certain types of deposit they have. What is your feeling about them getting into these different ventures? Shouldn't they be staying in their own field and start loaning money on houses?

FED SUPPORTS THRIFT TEST

Mr. MARTIN. We support, at the Federal Reserve, the so-called thriftiness or thrift test, in which the proportion of assets devoted to housing and housing-related activities—and here I am only addressing the savings and loan questions—be a certain percentage to be determined by the Congress. If an institution doesn't have that proportion of residential mortgages and residentially mortgage-backed securities—participation, interest, and so forth—then it should be treated, for regulatory and credit granting purposes, as another kind of institution.

It, of course, is impossible to specify that all of the assets should be in housing, because there are institutions operating in parts of the country in which there isn't strong housing demand. You don't want them to go out of the business entirely, but you know that they have to acquire some other assets.

Where should the line be? We hope that in addressing the nonbank bank and the other questions in this session of Congress, those decisions will be made, and then we will be told how to implement them.

Senator HECHT. But traditionally, savings and loan have gone into participation in other parts of the country into avenues they understand, mainly, home buying and home development. Can they be going into this with a better yield than going into speculating on their money which is brought in by the different ones into their organization?

Mr. MARTIN. Yes, Senator. In fact, if you look at the so-called phenomenon of the conglomerate of the 1960's or at the financial results of financial institutions going into a whole variety of new activities, you don't find the high rates of return on those activities, because they are getting out into terra incognita. So I think we have to be very—pardon me—I think that Congress has to be very careful in delimiting this kind of institution and that kind of institution.

For example, that is the reason why, in the proposed regulations of the Federal Reserve with regard to real estate development, we have proposed a circumscribing of that activity for banks. In other words, it may be fine for a commercial bank holding company

system to do some real estate development on a passive basis, but it shouldn't do a lot of it.

Senator HECHT. All I know about the Ohio situation is what I have read in the papers, as Will Rogers would say. But I was very kind of surprised about the huge amount of money this one savings and loan in Ohio had for speculative purposes in the Florida operation that went under.

Did you see those figures? I don't have them on top of my head, but it was a tremendous amount of money, and I wondered why were they taking this money and not using it for the purpose by which they were chartered.

Mr. MARTIN. They were involving themselves, management was involving itself, in highly speculative transactions, trading in the Government securities market, with the result that one institution was broken. The hearings yesterday before a House subcommittee indicated that resulting developments may have bankrupted the private fund set up to insure these 69 institutions. They were speculating in the Government securities market, and not many managements can do that successfully.

Second, there is strong indication from the official who is working out the ESM Government securities bankruptcy in Fort Lauderdale, that there may have been fraud associated with the ESM Government securities. Unfortunately, the savings and loan in Cincinnati was very involved in its trading with ESM Government securities. There may even have been some aspects of fraudulent transactions.

Senator HECHT. Just basically off the top of your head, do you recall the footings of the savings and loan in Ohio that was dealing with this?

Mr. MARTIN. The total footings?

Senator HECHT. Yes.

Mr. MARTIN. Between $4 billion and $5 billion total assets.

Senator HECHT. They had about $150 million in speculative activity; is that about right?

Mr. MARTIN. No, sir; they had positions between $600 million and $700 million in the Government securities market, including $400 million GNMA's, $200 million in Treasury's, for example.

Senator HECHT. Well, then, they were over their limits as far as their charter.

Mr. MARTIN. Well, it's a State-chartered, private—I must use the past tense—may it rest in peace—it was a State-chartered, it was a privately insured, to give it a benefit of a doubt, privately insured institution, working under the laws of the State of Ohio, which have been, I hate to say liberal. Manager's purviews have been greatly expanded by the State legislature, you know. Lucky you, now you can invest in all kinds of things like Government security positioning.

Senator HECHT. You answered it very well, thank you.

Mr. MARTIN. You're welcome, sir.

Senator D'AMATO. I would come down to that issue again as to whether or not those institutions that have FDIC or FSLIC insurance should be undertaking those kinds of speculative activities. Should the American taxpayer be providing that kind of insurance for these activities?

Mr. MARTIN. No, sir.

Senator D'AMATO. And I think the Congress is going to have to, and I'm going to be interested to listen to Mr. Wright, give him an opportunity to prepare for that question, what we in Congress should do if anything, to prevent that occurrence.

Senator Sasser.

Senator SASSER. Thank you very much, Mr. Chairman. I have a statement, an opening statement, which I would like to have incorporated in the record, Mr. Chairman.

Senator D'AMATO. So ordered.

LESSON FROM HISTORY

Senator SASSER. If I may be allowed a misquote, a famous writer said something to the effect that those who don't learn the lessons of history are condemned to repeat them. And this business of having a wave of corporate takeovers is not new. The first recorded peak of merger and acquisition activity occurred at the turn of the century, according to the Council of Economic Advisers, as the Nation recovered from the depression of 1893 and before it slipped into the recession of 1904.

The second peak occurred preceding the Great Depression of the 1930's, during the rapid economic growth of the late 1920's; then we slipped into the Great Depression of the 1930's that took us over a decade to recover from.

So even if the current hostile takeover binge is not especially different from previous ones that we've seen in the 20th century, which have occurred during the high speculative fervors, and which were followed, as we've seen, by major recessions and a depression, aren't the costs we pay for these waves of speculative takeovers extraordinarily high, Mr. Martin, to the point that we ought to take some steps to try to control them?

Mr. MARTIN. Well, certainly, the distress, the unemployment, the bankruptcies which have occurred in those heavy recessions and depressions over that historical period to which you allude is a heavy price to pay. I guess that then one has to say what aspects of merger and takeover and buyout activity should be restricted. To say to an incumbent management, "Don't worry, nobody can ever buy you out," is not a desirable alternative. We've all seen companies that after several decades became less concerned with their publics and thought they kind of had it made. "We're the biggest firm in this industry. We've got 45 percent of the market. Don't worry. You know, we've got these branches all over the country."

Certainly, merger and takeover activity is worthy of attention. There appear to be abuses, which is why I think this review is so appropriate.

Senator SASSER. Well, in your statement, you seem to indicate that you're not quite as concerned perhaps as Chairman Volcker about the dangers posed to the banking system by the increase in leveraged buyout activity, which dramatically increases the level of debt relative to equity overall.

And I gather that you are attempting to steer the committee away from any action that would appear to be credit allocation, as you refer to it.

Now you recommend instead that Congress should review the features of the tax system that appear to encourage merger activities, and point the finger at the tax system to some extent, as I understand it, and particularly at those features that favor the use of debt financing.

Now my question really is twofold to you, Governor Martin. Are you implying that the current tax system acts as a form of credit allocation through its incentives?

And the second part is what would happen to the level of merger and acquisition activity in general and leveraged buyouts in particular if these tax incentives were removed?

Mr. MARTIN. Well, sir, if I may, I yield to no man, even my esteemed and honored colleague, Paul A. Volcker, in my concern with regard to the safety and soundness of the financial system. I think I can say that with some weight in that I have now spent 10 years of my life in supervisory work at the State and the Federal level. I wouldn't even want to admit how many forced mergers, supervisory mergers, liquidations occurred in this time. I've seen the distress that they cause, including distress to communities, when something has to be liquidated.

Well—but that's a speech that the chairman is about to use his gavel on, so I'd better answer your question, I think.

INCENTATIVES THROUGH THE TAX SYSTEM

With regard to the tax system as a means of allocating resources, of course it does. And it has been over the course of our recent history the intent of this body and the other body to effect the allocation of resources with the tax system; certainly, it is not for somebody from the Federal Reserve to sit up here and say that process was incorrect. That's the system we have.

If you see fit to legislate in the area of leveraged buyouts, mergers, acquisitions, unfriendly mergers, friendly ones, and so forth, it will tend to I think—at the margin, not in a big way—change the allocation of resources. And no person knows until these statutes are on the books and a lot of clever lawyers figure out ways to use them, how that allocation would change.

But, it looks to me as though indeed it would, sir.

Senator SASSER. Well, do you think that if the so-called tax incentives that are in the Tax Code which you appear to believe encourage merger and acquisition activity, and I think others make that case very persuasively, if these tax incentives were removed, would you see a substantial diminishing in leveraged buyouts across the country?

Mr. MARTIN. Yes, I think certainly a dimunition from what those leveraged buyouts would have been otherwise. There is a trend, though, toward smaller organizations. I have a little bit of a prejudice in that regard, I admit, in favor of smaller organizations and of divestment or deconglomeratization, or whatever the word is—that's probably undoubtedly not the word. I think some of this activity will go on anyway. That is, if you've got a group of managers under a holding company, a remote holding company, and they think, if we controlled this company, we could do this and that and

this and that, I think, tax incentive or not, that group of managers is likely to do the leveraged buyout.

I think there will be more of an impact in the unfriendly acquisition area.

Senator SASSER. In your testimony, you described a policy directive that was issued in 1984 to examiners at each of the 12 district Federal Reserve Banks, and that directive, sent by the Federal Reserve Board's Division of Banking Supervision Regulation, pointed out the high volume of debt relative to equity that is characteristic of leveraged buyouts and that it increases the risk to financial institutions.

In general, what sort of response has the Fed had to that directive?

Mr. MARTIN. Well, we have had the anecdotal kind of response from banking groups and from bankers who, when they've come into the Fed, or we've been in meetings with them, have discussed this area and are aware of what our examiners are increasingly doing about it.

We have had in examination reports the results of this process, of——

Senator SASSER. Well, let me be more specific, Governor Martin. I'd like you to address guidelines Nos. 5 and 6. No. 5 requires that total loans to finance leveraged buyouts should be treated as a potential concentration of credit, and if large enough, should be listed on the concentrations page in the examination report.

Mr. MARTIN. Yes, sir.

Senator SASSER. What is your assessment of the current level of concentration based on these reports and on other sources?

Mr. MARTIN. I will have to research this and report back to the Senator. I don't have data on that. What we're trying to do with No. 5, of course, is to say: Just as you would criticize a management for over concentration in energy loans or some other industrial area wherein they have too large a pile of this kind of loan, that's a concentration and treated as one for risk analysis purposes.

But I will get back to the Senator.

Senator SASSER. Governor Martin, if you would do that and furnish that information for the record, I think it might be very helpful.

Now guideline No. 6, continuing on this same line, requires that significant deficiencies or risk regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

How effective has guideline No. 6 been so far, in your judgment?

Mr. MARTIN. I will again have to respond to you. But, let me tell you as one who has been involved in examination for quite a few years, if you put something on the first page, you bring that to the attention of the board of directors, and you give it heavy, heavy emphasis. Management does not like to have things brought out to their board of directors. That's where the old saying is "The rubber meets the road."

Senator SASSER. Right.

My time has expired. Thank you, Governor Martin.

Senator D'AMATO. Senator Sasser, do you have any more questions of Governor Martin? If not, we'll proceed to Deputy OMB Director Joe Wright, who has been waiting patiently.

Senator SASSER. I have no further questions, Mr. Chairman.

[The complete prepared statement of Senator Sasser and additional information supplied by Mr. Preston Martin follow:]

STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman. We have here with us this morning three of the key policymakers in the Federal Government with a direct interest in the issue of hostile corporate takeovers.They are also regulators, with responsiblity for maintaining the safety and soundness of the national economy.

I think that's an important distinction to make. The debate that has been carried on in the media in the last couple of years, about these takeovers, has focused in large measure on the gamesmanship, the casino-type atomsphere of these multi-billion-dollar transactions. That is understandable. It is probably more entertaining to read about shark repellents, poison pills, and scorched earth defenses than to worry about the effect of these glamourous sounding games on the national economy; or on the soundness of our financial system; or on the long-term future of corporate America.

There are vital economic issues at stake here, and I want to address a number of them this morning.

The recent wave of merger activity has been called the leveraging of corporate America. I believe Mr. Lipton used that term in his testimony yesterday. Leveraged buyouts, at the rate and scale at which they are proceeding, are transforming equity into debt in this country at an alarming rate. And, as Chairman Volcker has pointed out, an economy based on debt is much more susceptible to an economic downturn. Having witnessed the devastating effects of the recession of the early 1980's, as all of us did, I am frankly concerned about the apparent lack of concern, in some quarters, about the potential for even more serious damage, in a highly leveraged economy.

We have financial institutions at risk, we have investors at risk, we have corporations at risk,

There are also, obviously, some key issues involving shareholder rights and the fairness of the market system. Senators Proxmire, Riegle, and Metzenbaum have introduced some very strong pieces of legislation on this score, and I know this subcommittee, and the full committee, are giving very thorough consideration to the approaches they are recommending.

I also have some questions about the effect of current tax policy on this merger phenomenon—whether in fact the Government is providing a dangerous subsidy to this practice of hostile takeovers, and getting no public policy benefit in return—such as the creation of jobs or the maintenance of stable communities.

I look forward to hearing from the witnesses this morning and to hearing their response to some of these questions.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

PRESTON MARTIN
VICE CHAIRMAN

May 1, 1985

The Honorable James R. Sasser
United States Senate
Washington, D.C. 20510

Dear Senator Sasser:

During hearings before the Subcommittee on Securities of the Senate Banking Committee conducted on April 4, you raised certain questions regarding procedures 5 and 6 of the Federal Reserve's leveraged buyout loan examination guidelines. In particular, you requested my assessment of the level of bank concentrations in financing leveraged buyouts and the effectiveness of the procedures in bringing this activity to the attention of the bank's board of directors.

The Federal Reserve's guidelines define aggregate leveraged buyout loans as potential concentrations of credit that are to be identified in the examination report if the aggregate of such loans exceeds 25 percent of capital. Such treatment is not necessarily meant to imply criticism of the individual loans or of the bank's lending practices, nor does the 25 percent-of-capital level per se constitute an excessive or unwarranted level of exposure. Potential concentrations in leveraged buyout credits differ somewhat from the conventional notion of loan concentrations since the latter implies an aggregation of loans to related borrowers or a single industry, while leveraged buyout loans may involve borrowers from many different industries. While not necessarily implying criticism, treatment of leveraged buyout loans as a potential concentration of credit is designed to focus management's attention on the possible risks associated with this type of financing. If deficiencies are found regarding these credits, or if it is believed to be appropriate to bring supervisory views on the bank's involvement in leveraged buyout financing to the attention of the bank's directors for any other reason, the leveraged buyout lending activities are discussed on page one of the examination report.

In response to your questions, the Board's staff has surveyed supervisory personnel at the Federal Reserve Banks who are responsible for examining state member banks. Our survey suggests that most state member banks have little or no involvement in leveraged buyout financing, although such financing represents a significant activity for a small number of the larger state member banks. In general, the quality of credit

and loan administration procedures of state member banks appears satisfactory, although if deficiencies are noted they are brought to the attention of management. During on-site examinations, leveraged buyout loan portfolios are reviewed to determine the degree of diversification in the portfolio as well as the cushion against unfavorable interest rate movements that are inherent in individual loans. In addition, individual leveraged buyout loans are, of course, evaluated as part of the standard loan review process, and any loans that have been found to entail significant credit weaknesses would be criticized or classified by the examiners and factored into the Federal Reserve's assessment of the bank's asset quality, capital, and overall financial condition. Prudent banking practice requires that leveraged buyout credits be subject to a loan review and approval process that reflects the high levels of debt involved, and larger exposures warrant the full knowledge and continuing involvement of the bank's directors. For this reason and to underscore our supervisory views regarding leveraged buyout financing, concentrations of credit have been (or, in the case of those institutions currently under examination, will be) discussed on page one of the examination report.

I believe these steps have contributed to a heightened awareness by management and directors of the potential risks associated with these activities and have complemented other actions by the Board of Governors to express its concerns to leaders of the banking community regarding merger and leveraged buyout financing. I also believe that, taken together, these actions have encouraged the banking community to review their lending policies and should help to foster prudent lending and loan monitoring practices.

Please let me know if I can be of any further assistance to you in this matter.

Sincerely,

Preston Martin

Preston Martin

Senator D'AMATO. Governor Martin, let me thank you once again.

Mr. MARTIN. [Italian.]

Senator D'AMATO. Been taking lessons from Mama.

Good seeing you, Preston.

Good morning, Joe.

Mr. WRIGHT. Good morning, Mr. Chairman.

Senator D'AMATO. Mr. Ginsburg.

Mr. GINSBURG. Good morning.

STATEMENT OF JOSEPH R. WRIGHT, JR., DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY DOUGLAS GINSBURG, ADMINISTRATOR, OFFICE OF INFORMATION AND REGULATORY AFFAIRS, OFFICE OF MANAGEMENT AND BUDGET

Mr. WRIGHT. Mr. Chairman, accompanying me is Doug Ginsburg, who is head of our Office of Information and Regulatory Affairs. We've prepared a very long statement, as you may have seen. I'd like to submit it for the record, with your permission, please.

Senator D'AMATO. We'll accept it into the record as if read in its entirety.

Mr. WRIGHT. Thank you. I apologize for the length of this statement. What we're trying to do is to add a little bit of quantitative analysis to this area of emotional——

Senator D'AMATO. Joe, could you speak right into that mike?

Mr. WRIGHT. Sure. What we are trying to is to add a little bit of quantitative analysis to this whole area that seems to be plagued with a lot of emotion; and also address some feelings that actions should be taken, although there's disagreement across the board from almost every source as to exactly what that should be.

ADMINISTRATION'S POSITION

If I may just very quickly state the administration's position in this area at this time, I would appreciate it.

We feel the issues that are raised, and we appreciate the subcommittee holding the hearings at this time on these issues because we do believe they are important, really go to the core of this Nation's fundamental beliefs about not only our market economy but also, and equally important, the appropriate role between State and Federal Governments.

I think one of the significant guiding factors in the discussion should be that there is substantial evidence that corporate takeovers as well as mergers, acquisitions, and divestitures, are, in the aggregate beneficial for stockholders and the economy. They perform several valuable functions. I will not go into them in detail, Mr. Chairman. I think this has been discussed at length this morning and yesterday, so I don't want to repeat.

I would like to say, however, takeovers are not random events and, many times, they take place because a company's management has, over a long period of time, failed to deliver to stockholders the full value of the assets that are owned by that company.

In many cases, Mr. Chairman, the takeover bid provides stockholders with a chance to realize the value that the encumbent management has failed to deliver.

Numerous studies have shown that the stockholders of both the target and the bidder companies benefit. Target shareholders gain premiums of around 30 percent. Bidder shareholders gain about 9 percent on their investment. This data is for both friendly and hostile takeovers.

Unfortunately, a hostile takeover is the only way that the shareholders may have to gain the premium or to gain the true return on their investment.

Attention recently was drawn to at least four factors that allegedly are drawbacks on takeover transactions:

The corporate management time drain that is spent in fighting these takeovers; excessive corporate debt that is generated as a result of these takeovers, or fighting the takeovers; inadequate long-term investment; and job losses and community disruption.

We believe that many of these concerns are rooted in a desire by management to preserve the status quo in the existing corporate structure. Our review convinced us that these allegations are not really supported by facts, and we're concerned that any legislative attempts to control takeovers, particularly for these reasons, could be ineffective at best and harmful at worst.

We feel this area is already regulated by the Williams Act and other provisions of security laws. We believe that existing provisions adequately achieve investor protection goals.

But we would like to say that like most things that we do in the Federal Government, both in the executive and legislative branches, when we regulate it imposes a cost. We feel that these provisions have been effective, but there are fewer takeovers as a result and there may have been a cost to the economy.

The defensive techniques that are employed by managers who desire to fend off these hostile takeovers do present a different problem; we recognize this.

We think that there is a real potential for abuse in the use of defensive tactics. The Chairman mentioned greenmail as a bidder abuse. With all due respect, I would count greenmail as an abuse on the defensive side. I would not fault those who are called "raiders" for taking greenmail as much as I would corporate managers for offering it.

We feel there is a potential for abuse in this area. However, we've seen that managers who initially opposed many of these hostile takeovers, in many cases, do so in order to get a higher premium for their shareholders. There is nothing wrong with that. This is a normal bidding process that occurs every day. We think it's extremely important when either the executive branch or the legislative branch looks at this issue that they try to define the difference between the intent of those managers who are trying to resist takeovers and those who are trying to induce higher bids.

I'm not exactly sure how you'd do that, and that's one crux of the problem.

The task of identifying and controlling potential abusive conduct by target managements, we must say, has traditionally and properly been a matter for State, not Federal, law. Under State corpora-

tion law, stockholders have a variety of legal and contractual mechanisms they can use to protect themselves from management abuses, including corporate charter amendments. I don't know the number but I've heard 400–500 companies have enacted some type of antitakeover corporate charter amendments. It is happening as we are sitting here right now at an ever-increasing volume.

Stockholders can also protect themselves through proxy contest, management contracts, and finally, court action.

In light of all this evidence, we believe that Federal intervention at this time is entirely unwarranted. The balance between management's need to act expeditiously in the interest of the corporation, and the shareholders' right to call that action into account should be resolved at the level closest to the problem and with the least amount of Government intervention.

In summary, only if there is a serious market failure of national dimensions should the Federal Government consider taking appropriate steps to curb the potential for management abuse.

This concludes my statement, Mr. Chairman. I would be happy to answer whatever questions you may have.

[The complete prepared statement follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

STATEMENT OF JOSEPH R. WRIGHT, JR.
DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

APRIL 4, 1985

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Administration's views on corporate takeovers. Several large and contentious contests for corporate control have recently become the focus of national attention. It is important to recognize, however, that corporate takeovers -- whether friendly or hostile -- can serve several important functions in our economy. I want to commend you, Mr. Chairman, and the members of the Subcommittee for holding this series of hearings to carefully review the evidence and the assertions, many of which are made without regard to the evidence, that relate to this highly charged subject.

Last year some members of the Congress appeared ready to react too hastily to heavy media attention to perceived abuses. The issues raised in the debate over contests for corporate control, however, go to the core of this Nation's fundamental beliefs about both our market economy and the appropriate role of the State and Federal governments. As a result, these issues must be approached with the utmost care. A mistake could have serious consequences for the capital markets and our system of federalism.

Corporate Takeovers Can Have Positive Impacts On The Economy

Perhaps the most significant guiding factor for this discussion should be the substantial evidence that corporate takeovers as well as mergers, acquisitions and divestitures are, in the aggregate, beneficial for stockholders and for the economy as a whole. More specifically, takeovers can perform several valuable functions:

- Allocate resources to higher valued uses. Some publicly traded corporations own assets that can be used more profitably in other lines of business. By shifting a target company's resources to new applications, a takeover can cause a target to become more productive and profitable.

- Promote economies of scale and scope. Bidders may have resources that can be combined with the target's to produce better products at lower cost. These cost savings make the combined company more competitive and are beneficial for the economy as a whole. In addition, there can be opportunities for technology transfer, expanded marketing expertise, new distribution channels, and other efficiencies that can result from the combination of resources.

- Increase the return from investments in the stock of publicly traded companies. Investors buy shares because they expect to earn a profit. The lower the opportunity for profit, the less the incentive to invest, and the higher the cost of capital. One way an investor can profit is to sell his shares for a premium in a takeover. If the opportunities to sell at a premium are reduced, by Federal or any other type of regulation, the potential return to equity investment falls and the incentive to invest declines. Even the possibility of a takeover at a premium benefits publicly traded companies by increasing the value of their shares and thereby reducing the cost of equity capital. It should also benefit the economy as a whole by increasing the incentives to invest in publicly traded securities.

- Reinforce market incentives that require management to compete effectively. Profit opportunities can also arise when investors identify poorly managed companies and mount a takeover to replace management or reorient the corporation's strategy. Consequently, in order to prevail in the market for corporate control, it is not enough that an incumbent management believes that it is doing an efficient job, or even that it persuades stockholders that it is operating efficiently. It appears that management must also now demonstrate to investors that its performance is competitive with the performance of any

potential new managers. If investors have confidence that incumbent management is more capable than other potential managers, that confidence should be reflected in the value of the corporation's shares, and a takeover of the company will be relatively difficult. Otherwise, the reverse may occur. Managers that do not deliver 100 cents on the dollar to their stockholders are failing their stockholders. Takeovers are a natural and productive capital market response to that failure.

This point has been reflected by the statement in Business Week last March 4, in which Raymond L. Watson, Walt Disney Productions' Chairman during the attempts to take it over last year said: "It woke us up, though I hate to give credit to something like that. I think the company is stronger." The significant increase in Disney's stock price since their restructuring, notwithstanding two greenmail payments, indicates that the market agrees.

- Free up capital for new investment opportunities. Takeovers are often financed by debt that is secured by the acquired company's assets. The unused ability to borrow against these assets suggests that the target company either may not have had investment opportunities that were sufficiently profitable (and should therefore have been distributing capital to stockholders to invest

in other ventures), or that management did not properly leverage the firm to take advantage of existing opportunities. In either event, the stockholders who receive the premiums made possible by such refinancing can then reinvest those sums in other business opportunities that make use of the capital previously untapped by the target company. This investment fuels economic growth in businesses that may be wholly unrelated to a specific takeover transaction.

There is another, often forgotten point. Recently, there has been a trend toward divestitures and spinoffs in which conglomerates, in an effort to focus on a few core businesses, divest operations to smaller enterprises. Although sound economic reasons may be the primary cause for such divestitures, the threat of a takeover provides an additional incentive for managers to make that sometimes painful decision. Such divestitures often follow takeovers of diversified companies. If divested assets are better managed by smaller, more focused firms, or if the diversified firm's operations can be improved by concentrating on core businesses, a takeover that leads to divestitures can be beneficial for the parent company, the buyers of the divested operations, and the economy as a whole.

The relationship between undervalued assets and takeovers underscores the important role that takeovers play in the operation of our Nation's capital markets. Our capital markets

are the most efficient, liquid, and creative in the world. Our capital markets work because they reward success and penalize failure. Indeed, sheltering publicly traded corporations from the discipline of the marketplace threatens the integrity of the marketplace.

Corporate Takeovers Also Are Beneficial For Stockholders Of Both Target And Bidder Companies

Takeovers are not random events occurring without rhyme or reason. They often take place because a company's management has, over a long period, failed to deliver to stockholders the full value of the assets owned by that company. In such cases, takeover bids provide stockholders with the chance to realize the value that management has been unable to deliver.

These observations are supported by numerous, highly detailed studies demonstrating that shareholders of both target and bidder companies realize significant wealth gains in successful takeovers. These studies find that, in a successful takeover, target shareholders gain premiums of about 30%, on average. (A graph describing returns to target company stockholders in 183 takeover contests is attached as Figure 1.) Bidder shareholders gain about 9% on their companies' takeover investments, on average. Thus, the evidence is that takeovers, in the aggregate, are beneficial to stockholders of both bidder and target firms as well as contribute to national wealth.

Stockholders Benefit From Both Friendly And Hostile Takeovers

The potential benefits of takeovers apply to both friendly and hostile takeovers. Indeed, it is sometimes difficult to distinguish between the two types of takeovers given the target management's incentives to bargain for a high price. Some critics of takeovers have proposed to restrict or limit only hostile takeovers in order to "temper" what they believe is a waste of resources that is caused by the conflict in such takeovers. Generally, any takeover bid that the Board of Directors does not approve is considered hostile.

Hostile takeovers, however, serve a critical and unique role in the relationship between the shareholders and managers of publicly held corporations. A hostile takeover is, in some circumstances, the only feasible means of replacing a management team that is not operating in the shareholder's best interests, because it can be the only -- or the most efficient -- way another group of managers can "go over the heads" of the corporation's incumbent managers and take their case directly to the owners of the corporation, the shareholders. Given our widely dispersed ownership of public corporations, and some managements' interest in preserving their incumbency at shareholders' expense, this is a crucial check in the system.

Recent Concerns Have Been Expressed About Negative Effects Of Takeovers -- The Administration Believes These Concerns Are Unfounded

Attention has recently been drawn to four factors that allegedly are drawbacks of takeover transactions. First is the claim that the threat of a hostile takeover is a wasteful drain on the time and energy of corporate managers. Second is the concern that takeovers increase corporate debt burdens and result in "unhealthy" debt-equity ratios. Third is the concern that takeovers and the threat of takeovers cause managers to emphasize short-term results to the detriment of long-term investment. Fourth is the claim that takeovers are often "bust-up" transactions that cause the loss of jobs and disrupt local communities.

Although sometimes voiced by well-meaning observers, these concerns are often unfortunately rooted in a desire to preserve the status quo of existing corporate structure in a fashion that can be harmful to stockholders and to the economy. Our reactions to these concerns are as follows:

Corporate Management Time Drain. Corporate managers appear to be focusing on two concerns when they consider the possibility that the corporation they manage could become a takeover target. The first concern, hopefully, should also be the best defense -- how to run the company as efficiently as possible and communicate

that information in such a way that the market will value the company's future propects (and stock) as highly as possible. If the company is well run and the market knows it, potential bidders will find little to gain from a takeover and will look elsewhere. After all, the bidder must pay a significant premium over the market price to gain control. Most observers would agree that the best takeover defense is therefore a high stock price. It is difficult to characterize this use of managements' time as wasteful. On the contrary, we believe that is exactly what managers should be doing and the threat of a hostile takeover provides an added incentive to do just that.

The second concern that corporate managers seem to be discussing with increasing frequency is what to do if, regardless of their best efforts to increase the value of the company's shares, some bidder believes that he can manage the company's assets better than incumbent managers -- and is willing to take the risk with his own money to prove it. If such a bidder materializes, the corporation's managers may become preoccupied with how to prevent him from gaining control. The stakes are high -- the corporation's future strategic direction and, possibly, managements' jobs. Given the importance of the strategic debate the preoccupation may or may not be excessive. Even if management does become "excessively" preoccupied with preserving corporate independence, however, it is important to remember that, in most cases, it is in that position only because it failed in its execution of the best defense and someone else

is willing to bet with their own money that they can do a better job. We do not believe that protecting incumbent managers from such competition would be healthy for our economy or fair to their shareholders.

Debt-Equity Ratios. At the outset, it is important to recognize that there is no such thing as "the correct" debt-equity ratio. Debt-equity ratios vary over time, across industries, and among companies within an industry. Every year, hundreds of companies decide to raise capital by issuing debt instead of selling equity. These decisions have nothing to do with takeover activity and are based solely on prevailing market conditions. Quite simply, when the cost of debt is lower than the cost of equity, a company will increase its debt-equity ratio in response to the market's signal that debt is the most efficient means of raising new capital. The market, not the government, is the best judge of the suitable debt-equity ratio for a given company, or industry, or for the economy as a whole.

The same holds true in takeover transactions. The amount of debt and equity used to finance any given takeover depends on a variety of factors, and is determined in arms-length negotiations involving lenders, equity investors, and corporate management. These financiers and executives are, as rule, highly sophisticated. They are fully able to negotiate for whatever protection is necessary and appropriate in light of the risk of default associated with lending to a highly leveraged firm.

In any case the available data require us to reject the notion that debt financing of hostile takeovers is of any significance to the economy as a whole. Figure 2 illustrates post-war trends in debt-equity ratios for nonfinancial corporate businesses, as measured by the Board of Governors of the Federal Reserve. Measured on a current value basis (with assets valued at their replacement cost), debt-equity ratios have declined since 1970, and are now roughly at the same level as in the late 1950s.

Measured on a historical cost basis (i.e., with assets valued at historical cost less accumulated depreciation), debt-equity ratios in 1983 were close to a post-war peak. However, the steady upward trend in this indicator dates back to the early 1950s, and it is impossible to draw any connection between the steady increase in debt-equity ratios measured on an historical cost basis and recent takeover activity.

Measured on a market basis, debt-equity ratios have been much more volatile, largely because of fluctuations in stock market valuations. The major increase in this measure of debt-equity ratios occurred in the early 1970s. Many analysts attribute that increase to oil price shocks and stagflation that depressed the market value of corporate equity and provided incentives for debt financing. But, in any event, it was not caused by takeovers. Indeed, market value debt-equity ratios have declined from 1981

through 1983, a period of relatively high takeover activity. Thus, even by this volatile measure, there is no reason to believe that takeovers affect aggregate debt-equity ratios.

Business Week's recent analysis of large corporations' balance sheets also suggests a trend toward lower debt-equity ratios, and helps explain the prevalence of leveraged financing activity in the petroleum industry. As shown in Table 1 (attached), debt-equity ratios for large, publicly traded corporations have declined from 62.1%, on average, in 1981-82 to 58.5% in 1983-84. The debt-equity ratio for the petroleum industry is about sixteen percentage points lower than for a composite of all industries. In addition, the debt-equity ratio for the petroleum industry has also declined from 45.4% in 1981-82 to 41.8% in 1983-84. Thus, debt-equity ratios appear to be declining in the aggregate, and the petroleum industry is less leveraged than the rest of the corporate sector.

If it is the market's judgment that particular petroleum companies can achieve greater returns for their stockholders by increasing their leverage, then the market should reward the company for moving towards a debt-equity ratio that is more profitable for stockholders and consistent with prevailing financial market conditions. Incumbent managements can either respond to prevailing capital market conditions on their own, or they will find themselves vulnerable to restructuring proposals designed to increase the corporation's value to its stockholders.

In other words, managements who do not properly their companies' assets in response to prevailing market conditions most often have only themselves to blame for their vulnerability to takeovers. A management that does not maximize the value of its stockholder's investment invites corporate restructuring attempts designed to provide stockholders with greater returns.

Acccordingly, there is little reason for concern over trends in aggregate debt-equity ratios, and we are aware of no basis on which it can be argued that the leverage resulting from takeovers, especially hostile takeovers, poses a threat to the economy. Indeed, even if one considers individual, highly-leveraged transactions, the concern over the effects of leverage are generally overstated. First of all, large portions of the debt that result from takeovers are often quickly paid off by asset sales, the proceeds of which are used to pay down debt incurred in the acquisition. Second, in any given case, if a company fails for financial reasons -- such as the financial burden created by a high debt-equity ratio -- rather than for fundamental business reasons, its physical assets are likely to be deployed elsewhere in the economy. In a growing economy, moreover, most of a failing company's employees do not become permanently unemployed, although some may be dislocated and may have to find other jobs in other industries.

The valuable physical assets of a firm in bankruptcy are typically redeployed, and the company is often reorganized by renegotiating its capital structure. Equity investors and lenders absorb the largest part of the risk associated with the failed company's high debt-equity ratio. However, the capital market compensates these investors by paying them a return commensurate with the risk created by the borrower's high leverage. Indeed, data suggest that, on a historical basis, the risk premium offered to investors in highly-leveraged, high-yield investments (perhaps unfortunately labelled as "junk bonds" because they are not investment grade) has been more than adequate to compensate investors for the risk of default. There is, of course, no guarantee that risk premiums will continue to be adequate to compensate for the risk of default, but here again, the market is certain to be a much better arbiter of the appropriate risk premium than the government.

Viewed from an aggregate economic perspective, the adverse consequences of a failure due to a high debt-equity ratio are significantly less than the consequences of failure because of competitive weakness or fundamental changes in market conditions. Moreover, to regulate takeover activity in order to prevent high debt-equity ratios would not only be pointless and ineffective, it would also constitute the first step in adopting a form of credit allocation that can only weaken national economic performance.

Long-Term Investment. This concern is generally based on the belief that institutional investors, who now manage a large part of all publicly traded stock, have short time horizons and are willing to tender their shares to a bidder in order to make even a small profit. The thesis continues that corporate managers, to avoid allowing their stock price to fall and increasing the threat of a takeover will emphasize short-term earnings at the expense of longer term investments that would allow U.S. companies to compete more effectively in the international economy. A central assumption implicit in this thesis is that the capital market is systematically fooled by such behavior.

While it is impossible to show that corporate managers do not behave in the way this thesis describes, it is possible to demonstrate that their reasoning is without foundation and that, if they are behaving as described, it does them more harm than good. First of all, there is substantial evidence that the market can properly evaluate long-term investment by publicly traded companies and rewards companies for making good investments of this type. Some of this evidence is plain and simple: Young companies with no current profits, and no realistic prospect of earning profits for many years, are often able to raise investment funds by selling equity in the market. The market judges the relative merits of these companies' long-term investment programs and the market sets the price of their shares according to the risks and returns perceived in their long-term projects.

Numerous stock market studies also show that the market responds efficiently to publicly released information regarding a company's future prospects. Information regarding long-term investment is publicly available and there is no evidence that the market treats long-term investment information any differently, or that it is biased for or against such investments.

In addition, a recent empirical study by the SEC's Office of the Chief Economist also supports the conclusion that the market rewards rather than penalizes long-term investment. That study reviewed research and development expenditures, institututional ownership, and stock values in a large sample of firms between 1973 and 1983. If the "short-term" myopic market argument is correct, R&D expenditures should decline as institutional ownership increases, institutions should invest most heavily in firms with low R&D expenditures, and stock prices should decline when companies announce new R&D programs. The SEC's research, however, not only does not support these hypotheses, it flatly contradicts them. The research shows that:

- From 1980 to 1983, while institutional ownership in the sample firms increased from 30% to 38%, the firms' R&D expenditures increased from 3.38% of sales to 4.03%;

- Institutional investors favor firms that spend more on R&D -- the higher a firm's R&D expenditures, the higher the institutional holdings in that firm;

- Firms that are takeover targets tend to be firms that have invested less in R&D than other firms;

- Firms that are takeover targets have lower institutional ownership than non target firms; and

- Stock prices increase when firms announce new R&D projects.

Thus, claims that managers must avoid long-term investment in order to maintain institutional support for their stock price appear to have no basis in fact.

We should also remember that not all long-term investment is prudent or desirable investment, and that not all of management's long-term investment plans are good ideas. Sometimes the market tells management that the world doesn't need another billion dollar paper mill, or another expensive oil well in a remote corner of Alaska. If a long-term investment program causes a company's stock value to decline, the decline may be much more a reflection on the intrinsic merits of the long-term investment and not a criticism of its long-term nature. The capital markets are not fooled by shortsighted corporate strategies, and there is no reason to think they could be.

Job loss and local disruption. There is also no reason to believe that takeovers cause inefficient job losses or that they produce more plant closings, layoffs, or dismissals than would otherwise occur in an efficient, market economy. Takeovers may influence the time and place at which disruptions are felt, but such changes are inevitable if market circumstances call for a contraction in an industry. Moreover, painful as some local dislocations may be, the adjustments that cause those dislocations often also have beneficial economic consequences. For example, if a takeover reduces the combined companies' headquarter staff and corporate overhead by eliminating unnecessary duplication, that is an efficiency that reduces costs, lowers prices for consumers, and benefits stockholders.

The interests of America's workers are served far better by a growing economy that provides opportunities for new employment to those who may be displaced as a result of changing market conditions. New jobs are being created at a rapid pace, with 7 million new jobs having been created in the last two years. Job mobility is also high. About 9.7% of the workforce changed occupations within the last year, and about 27.3% of the workforce has been in its current job for less than a year.

The economy has been successful in creating these new jobs in part because of the dynamic nature of the free market system. It would be ironic to shackle the market for corporate control, and thereby hinder efficiency, in order to protect isolated vested

interests who seek to defend the status quo. Corporate management welfarism should not be promoted under the guise of saving jobs and protecting local communities against disruption.

In addition to the above concerns, there are often criticisms of takeovers that include adverse effects on competition, revenue losses due to tax-motivated transactions, and crowding business projects out of capital markets. Upon review, there does not appear to be any problem in these areas caused by takeover activity that would warrant additional regulation. Studies show that competition across industry has been increasing, and leveraged takeovers do not significantly affect the total capital market, as they represent only 1.3% of total commercial bank loans and investments, and an even smaller percentage of the total outstanding debt in the economy. Moreover, the premium prices paid in takeover transactions generally are reinvested in other debt or equity instruments and do not disappear from the financial system.

In summary, legislative attempts to control takeovers in order to reduce managers' worries, bring about lower debt-equity ratios, promote more long-term investment, prevent job loss, or avoid local disruption are likely to be ineffective at best and harmful at worst.

Existing Regulation Appears To Be Working Well To Curb Abuses In Takeover Activity -- But At A Cost

This Subcommittee recognizes that the market for corporate control insofar as it affects the integrity of the national securities market, is already regulated by the Williams Act and numerous other provisions of the securities laws.

The Williams Act. This legislation represents a compromise between (1) the desire to assure adequate disclosure to investors and to afford target company shareholders and their managements a reasonable period of time in which to evaluate tender offers, and (2) the market's need to operate efficiently and with a minimum of government regulatory interference. While the Williams Act has served a purpose in assuring adequate dissemination of accurate information to investors, it has also imposed costs on the operation of the capital markets.

The Williams Act guarantees target shareholders a reasonable amount of time -- specifically 20 business days (or 28 calendar days), close to a full calendar month -- in which to evaluate tender offers. The waiting period and prorationing requirements of the Act have eliminated the coercive "stampede" associated with some tender offers that were left open for very short periods of time (the so-called "Saturday-night-specials"). However, the Act achieved this result at the cost of making takeovers both more difficult and more expensive for bidders.

Studies show that the additional expense caused by adoption of the Williams Act has reduced the number of takeover transactions and has, in all likelihood, deterred some transactions that would have been beneficial for stockholders and the economy at large.

There Does Not Appear To Be A Problem With Alleged Bidder Abuses

Despite the existing protections offered by the Williams Act, various additional limitations on bidder activities have recently been proposed. No convincing need for these additional restrictions on bidders has been demonstrated, and calls for further legislation to curb allegedly "abusive" bidder practices should be rejected.

Two-tier offers. The two-tier tender offer is frequently cited as an allegedly abusive bidder tactic. Two-tier offers involve a uniform proposal that is made equally available to all target stockholders, however, typically the proposal is to pay one price in cash for the first 51% of all securities outstanding, and another (usually lower) price, in securities, for the remaining shares. The prorationing requirements of the Williams Act assure that this offer is equally available to all stockholders, and prevent "first-come first-served" offers that could provide an incentive to tender early in the waiting period.

Critics of two-tier tender offers claim that such offers are coercive because they can "stampede" stockholders into tendering their shares. This argument, however, ignores the empirical evidence. SEC staff has found that the blended premium in two-tier offers is not significantly different from the average premium available in single-tier offers. In addition, when two-tier and single premium offers compete, the highest bid wins, regardless of its type. Moreover, about half of all two-tier bids are made in friendly tender offers. The fact that target managements consistently recommend two-tier offers to their stockholders suggests that these offers have salutary traits that can be preferred by target company managers and stockholders. A two-tier offer may, for example, offer target stockholders a higher net premium because it is cheaper for the bidder to obtain financing by issuing securities in the second tier of the offer than to arrange financing through other sources. Or, in some transactions, some shareholders may prefer the securities offered in the second tier in order to avoid recognition of capital gains at the time of the takeover.

Minimum Waiting Period. Critics of hostile takeovers also claim that the twenty business-day (28 calendar day) waiting period is too short. Proposals have been submitted to the Congress to lengthen that period to either 40 or 60 calendar days. These proposals, if enacted, would increase the expense and uncertainty of takeover attempts and would provide target managements with even more time to engage in defensive tactics.

Accordingly, a longer waiting period would impose significant additional costs on the market for corporate control. These costs would not be offset by corresponding benefits because, as the SEC has concluded, the current 20 business (28 calendar) day waiting period is fully adequate for purposes of information and disclosure. Indeed, Charles Kittrell, Executive Vice President and Member of the Board of Directors of Phillips Petroleum, who on February 27, 1985 appeared before the House Subcommittee on Securities, Telecommunications, Consumer Protection and Finance explained that the current waiting period was fully adequate to inform Phillips stockholders.

When a proposed rule change will generate costs without yielding offsetting benefits, as is the case with lengthening the minimum waiting period, it makes no sense to adopt the change.

<u>However, There Can Be Abusive Defensive Techniques, Which Are Being Addressed By Corporate Charter Amendments, State Law, And The Courts</u>

Defensive techniques employed by managements who desire to fend off hostile takeovers present a different problem, and in these circumstances there is a real possibility for abuse. In a takeover contest, management's interests can diverge from their stockholders' interests because the stockholders' opportunity to sell their shares in a takeover places management's employment

status in jeopardy. Some managements may therefore oppose takeovers that would be beneficial for their stockholders. Among the techniques they use to try to thwart such takeovers are targeted share repurchases ("greenmail"), the sale of new securities to stockholders committed to support incumbent management, and the issuance of "poison-pill" securities without prior stockholder approval.

Extensive evidence shows that managements who claim that remaining independent is better for stockholders are generally incorrect because the defeat of a takeover bid typically causes average losses to target stockholders ranging from 15% to more than 50%. The results of one of these studies is illustrated in Figure 3.

There is, however, evidence that managements who initially oppose takeovers are, in about half of all contested takeovers, able to induce higher bids before eventually agreeing to a takeover (see Figure 4). Accordingly, it becomes very important to distinguish between (1) cases in which management opposes a takeover as part of a good faith effort to bargain for a higher premium, and (2) cases in which management opposes a takeover so as to assure the corporation's independence -- essentially at any cost -- and thereby preclude stockholders from the opportunity to collect any premium for their shares.

The solution to this problem is, however, to be found in a combination of market forces and developments under state law, such as amendments of corporate charters and litigation under the business judgement rule. Indeed, the task of identifying and controlling potentially abusive conduct by target managements has traditionally and properly been the subject of state, not federal law. Under state corporation law stockholders have a variety of legal and contractual mechanisms they can use to protect themselves from management abuses.

Corporate charter amendments and proxy contests. These can be employed by stockholders to limit management's use of potentially abusive defensive techniques. Stockholder suffrage has traditionally been viewed as a weak device for controlling management conduct, but increasingly important institutional investors are making the shareholder voting process a larger factor in checking management abuse. As of 1983, pension funds owned 23.1 percent of the value of corporate equity securities. When mutual funds and other institutional investors' holdings are added to the total, some analysts estimate that institutions control about 50 percent of the value of corporate equity. This trend toward increased institutional ownership of publicly traded securities is likely to continue. The Assistant Administrator of the Office of Policy and Research in the Office of Pension and Welfare Benefit Programs at the Department of Labor estimates that, by the year 2000, pension funds alone will own 51.9% of corporate equities.

Although it is dangerous to point to a single event as a sign of a trend, I would like to call to the Subcommittee's attention the recent decision by Phillips stockholders to reject the recapitalization plan proposed by Phillips management. Some analysts have suggested that this event is a watershed in the evolution of stockholder-management relations. In any event, rejection of the Phillips Petroleum Company's recapitalization plan demonstrates that stockholders are far from powerless, and that they have substantial ability to protect themselves from management action that is not in their best interest.

Another example of shareholder rebellion is now underway at Rorer Group, Inc. One of Rorer's major shareholders, Cooper Laboratories, Inc., whose Chief Executive Officer testified before you yesterday, is waging a proxy contest to force Rorer's management to rescind a "poison pill" that the Rorer Board of Directors adopted without shareholder approval. It promises to be an interesting contest, with potentially significant implications for other companies that have adopted or are considering adopting similar anti-takeover measures.

It is also noteworthy that corporations are successfully using charter amendments to forbid payment of "greenmail". At least five corporations have adopted such charter amendments in the last six months. In fact, any corporation that wishes to immunize itself against "greenmail" already has it within its own power to do so. Accordingly, regardless of one's beliefs about

the merits and drawbacks of greenmail -- and there may well be situations in which the payment of greenmail is objectionable -- any corporation whose stockholders want to immunize themselves from greenmail or even the "threat" of a hostile takeover or from other perceived abuses such as two-tier offers, poison pills, sale of crown jewels, and the like, is able to do so by adopting a wide variety of charter amendments. No corporation needs Federal legislation to achieve this result, so long as its stockholders agree. And, it appears that stockholders are now beginning to take these matters into their own hands.

Management contracts. Corporations can also use contracts to align stockholder and management interests more closely. For example, stock options give management an incentive to increase the value of the companies' shares, and thereby provide management with an incentive to behave in stockholders' interests. Golden parachutes can, in some circumstances, also serve a valuable purpose in this regard within the limits established in the Deficit Reduction Act of 1984. Managements who recognize that they do not need to defeat a takeover in order to preserve their own financial rewards may negotiate for a higher premium for stockholders rather than seek to defeat the takeover. Moreover, just as professional athletes negotiate "no-cut" contracts, the market for senior corporate executives may, in some situations, require that corporations offer equivalent forms of job security.

Court Action. In situations where these incentive and contractual mechanisms break down, the resulting breach of a management's duty of loyalty and care may be actionable in the courts. Although the business judgment rule has frequently been criticized as overly solicitous of incumbent management, recent developments suggest that courts are becoming more vigorous in their interpretation of the business judgment rule. For example, the Second Circuit Court of Appeals has recently held that a management's defensive efforts violated the business judgment rule. Delaware's Supreme Court has also recently ruled that a target management that fails to inform itself adequately regarding its responsibilities to stockholders violates the business judgment rule.

Federal versus State laws. In light of (1) the evidence that takeovers are good for both shareholders and the economy, (2) the existing checks on potential abuses provided by both the market and State law, and (3) the extensive freedom that stockholders and corporations have to fashion whatever protection they deem necessary and desirable against hostile takeovers, we believe that Federal intervention is unwarranted. The balance between management's need to act expeditiously in the interest of the corporation and the shareholders' right to call that action into account should be resolved at the level closest to the problem and with the least possible government intervention. State law has traditionally governed these matters and the states remain the proper forum for resolution of these controversies.

In Summary, Takeovers Are Beneficial For The Economy And Mechamisms Are In Place To Check Abuses -- Further Federal Intervention Is Not Warranted

In sum, the evidence is that takeovers are, in the aggregate, beneficial for the economy. They can allocate resources to higher valued uses; promote economies of scale and scope; increase the return from investing in the stock of publicly traded companies; reinforce market incentives that require managements to compete effectively; free up capital for new investment opportunities; and move assets to smaller, more focused companies.

The market for corporate control is already subject to extensive regulation, and further Federal intervention would be both unnecessary and unwise. Such regulation would likely impede the operation of the nation's capital markets and hinder economic growth on which future employment and investment opportunities depend. Further Federal regulation also runs the serious risk of intruding into areas that are traditionally and properly the subject of state regulation. Only if there is a serious market failure of national proportions should the Federal government consider taking appropriate steps to curb the potential for abuse. Otherwise, the Federal government should take no step towards the establishment of Federal corporation law to govern relationships between shareholders and managers.

It is difficult to see how the benefits of regulation in this area could possibly outweigh the costs. Also, since the Federal government has traditionally found it difficult to avoid over-regulation or to deregulate once the need for regulation has passed, simple prudence argues against Federal intervention in this market. Even if the Federal government did attempt to intervene, events are moving so rapidly in this area that the regulation would likely be outdated before it became effective.

When President Reagan was elected four years ago, he placed a high priority on deregulation and reduction of the Federal presence in the economy, the business community, and in every citizen's life. Much progress has been made in four years. This is not the time to reverse this trend. The Administration will continue to monitor developments in the market for corporate control and welcomes additional facts regarding the operation of that market. But there simply is no evidence at this time that Federal regulation can improve the operation of this market and thus, there is no case for further Federal regulation.

This concludes my formal statement, Mr. Chairman. I have attached a consise statement of the Administration's position. I would be happy to answer any questions you may have.

March 1, 1985

ADMINISTRATION POSITION
CORPORATE TAKEOVERS

I. Corporate takeovers perform several beneficial functions and are generally good for the economy.

II. The Williams Act represents a compromise between the desire to afford target shareholders and managements adequate disclosure and a reasonable period of time in which to evaluate offers, and the needs of the competitive markets in securities and in corporate control to operate with a minimum of government regulatory interference. We have not seen sufficient evidence that the existing provisions of the Williams Act are inadequate to achieve their purpose.

III. Various limitations on bidder activities have been proposed, but a need for additional restrictions on bidders has not been demonstrated.

IV. Target company shareholders need and have protection from abuses by target managements in conjunction with contests for corporate control.

V. State law, enforceable in the courts, governs the permissible terms of corporate charters, management contracts, and managers' and directors' fiduciary obligations, each of which may serve to check management abuses. From existing state statutes and decisions of state and Federal courts, however, it is unclear whether state law is adequate to protect target company shareholders from abuses by target management. As new defensive tactics evolve, moreover, existing protections may prove inadequate.

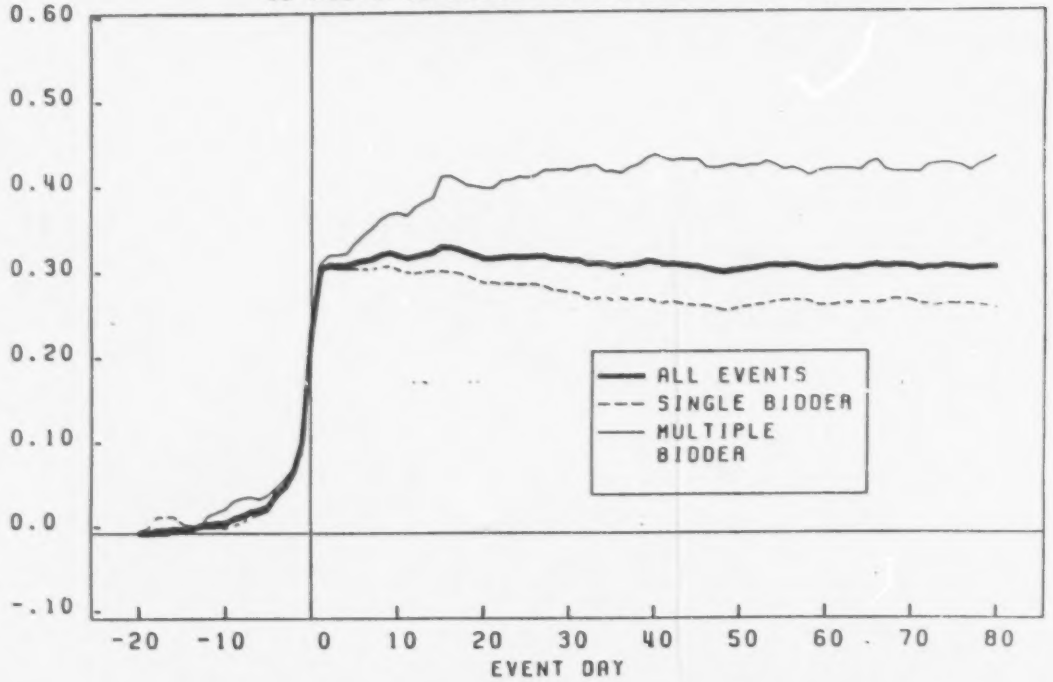
VI. The balance between management's need to act expeditiously in the interest of the corporation and the shareholder's right to call that action into account should be resolved at the level closest to the problem and the relevant facts--by the corporation, its owners, and managers in the first instance; by state law, if necessary; and, by Federal law only as a last resort. If there is a serious market failure of national dimensions, then the Federal Government should consider taking appropriate steps to curb the potential for abuse. Otherwise, the Federal Government should take no step towards the establishment of Federal corporation law to govern relationships between shareholders and managers.

VII. While matters of corporation law have traditionally been the subject of state rather than Federal jurisdiction, the Federal Government should play an informational role by making public the best information about critical issues that shareholders are likely to face in many corporate change of control contests.

VIII. The Federal Government should also carefully consider the unintended effects that other Federal policy decisions may have on merger and acquisition activity. To the extent that these Federal decisions encourage more or less merger and acquisition activity than otherwise would have taken place in a free market, resources may be misallocated.

FIGURE 1

CUMULATIVE ABNORMAL RETURNS TO THE PORTFOLIO OF TARGET FIRMS INVOLVED IN ALL 183 CONTESTS, 135 SINGLE-BIDDER CONTESTS AND 48 MULTIPLE-BIDDER CONTESTS, 1962-1980



Source: Bradley, Desai and Kim, Determinants of the Wealth Effects of Acquisitions, University of Michigan, August, 1984.

FIGURE 2

DEBT/EQUITY RATIOS: 1946–83

Source: Federal Reserve Board

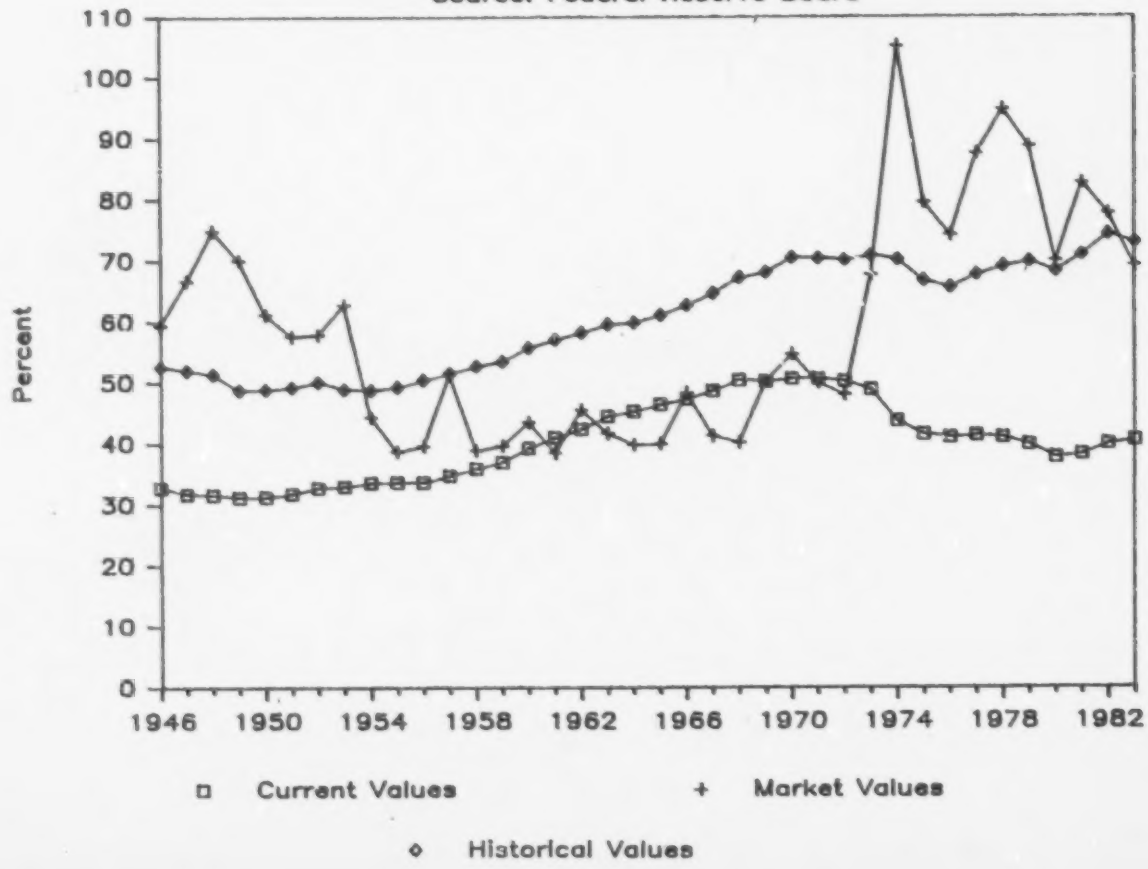


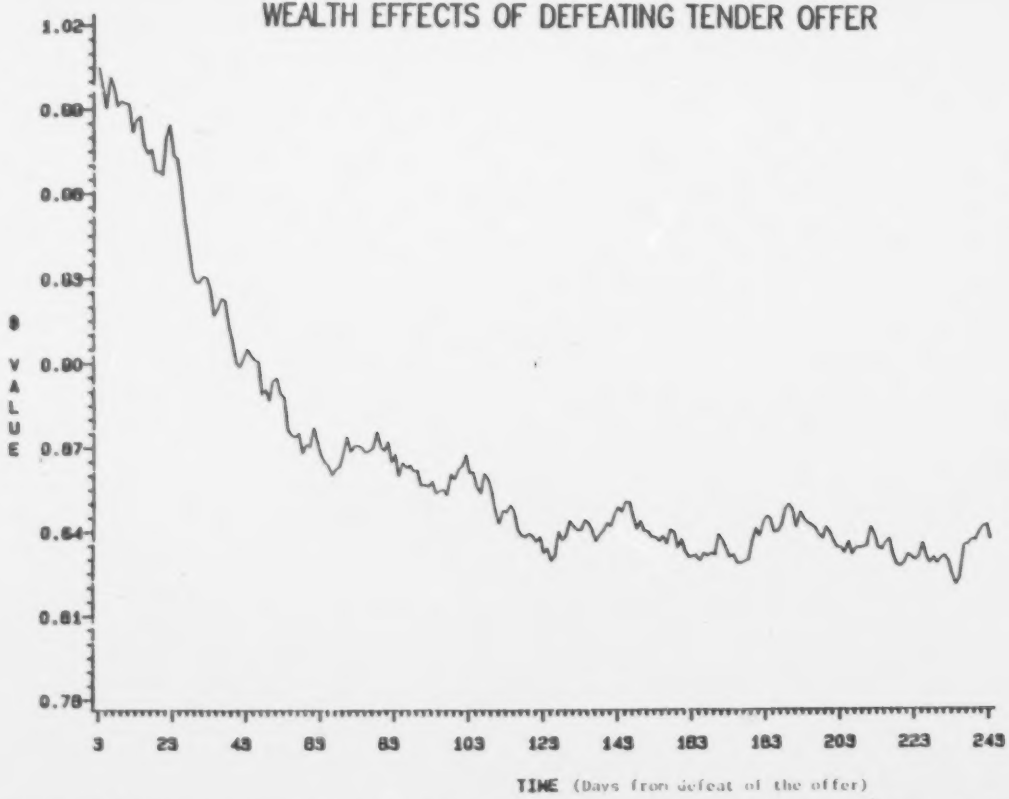
FIGURE 2a

DEBT/EQUITY RATIOS
FOR NONFINANCIAL CORPORATE BUSIENSSES
1946-1983
(All Data in Percent)

	Debt-Equity Ratios Based On:		
Year	Current Values	Market Values	Historical Costs
1946	32.87	59.44	52.62
1947	31.81	66.78	52.04
1948	31.70	74.94	51.43
1949	31.29	70.09	48.80
1950	31.34	61.16	48.94
1951	31.87	57.60	49.29
1952	32.89	57.89	50.17
1953	33.04	62.85	48.92
1954	33.66	44.38	48.84
1955	33.71	38.72	49.30
1956	33.74	39.70	50.51
1957	34.87	51.41	51.63
1958	36.00	38.93	52.76
1959	37.08	39.73	53.54
1960	39.37	43.56	55.77
1961	41.09	38.54	57.11
1962	42.48	45.60	58.20
1963	44.53	41.71	59.56
1964	45.38	39.84	59.89
1965	46.47	40.02	61.10
1966	47.43	48.40	62.72
1967	48.73	41.34	64.69
1968	50.50	40.24	67.24
1969	50.25	50.31	68.11
1970	50.74	54.67	70.53
1971	50.67	49.99	70.40
1972	50.27	48.06	70.15
1973	48.94	67.74	70.91
1974	43.85	105.21	70.21
1975	41.57	79.48	66.74
1976	41.08	74.17	65.62
1977	41.38	87.55	67.74
1978	41.12	94.79	69.10
1979	39.91	88.71	69.89
1980	37.84	69.97	68.30
1981	38.34	82.72	71.00
1982	40.02	77.66	74.27
1983	40.61	69.17	72.96

Source: Board of Governors of the Federal Reserve System, Balance Sheet for the U.S. Economy, 1945-83, pp 36-45, Table 705 (Nov. 1984)

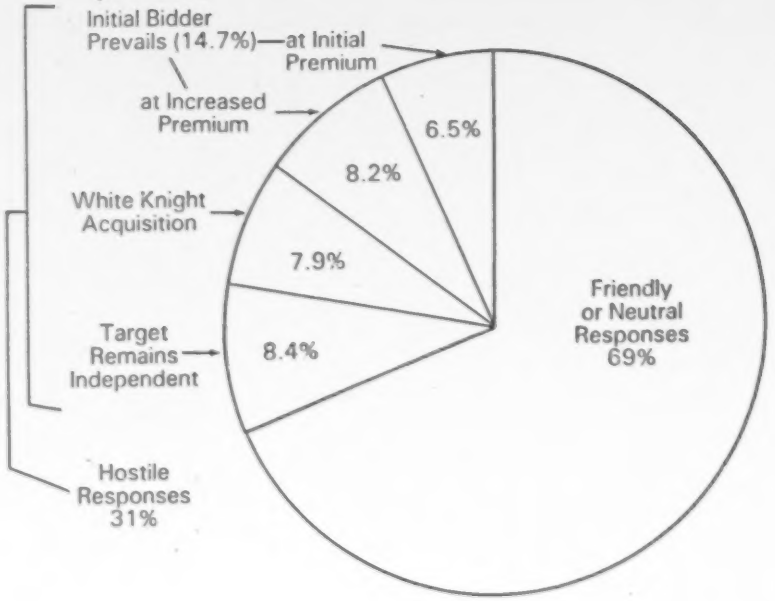
FIGURE 3



SOURCE: EASTERBROOK & JARRELL, DO TARGETS GAIN FROM DEFEATING TENDER OFFERS?, 59 N.Y.U.L. REV. 277 (1984)

FIGURE 4

Target Management Responses to and Outcomes of Tender Offers, 1978-83



Note.—Based on 429 tender offers.

Source: W.T. Grimm & Co.

Table 1

RECENT TRENDS IN

DEBT AS A PERCENTAGE OF TOTAL INVESTED CAPITAL

	1981-82	1982-83	1983-84
Ratio of Total Debt[1] to Equity[2]			
- All Industry Composite	62.1%	62.1%	58.5%
- Natural Resources (Fuel)	45.4%	47.1%	41.8%

Source: Based on Business Week, Scoreboard Special Issue, March 22, 1985 at 119, 134. The data presented in Business Week are debt-capital ratios. To convert these data to debt-equity ratios, the following formula was used:

When D = debt and E = equity, the debt-capital ratio as reported in Business Week is D/(E + D). The debt-equity ratios reported in this table and in the text are calculated as D/E.

1 "Total Debt" is long term debt (including present value of capital leases) plus short-term debt, measured as of the reporting companies' most recent fiscal yearend.

2 "Equity" is the sum of the value of a company's redeemable preferred stock, and common equity, including common stock, capital surplus, and retained earnings.

Senator D'AMATO. Thank you very much, Mr. Wright.

Let's look at that—and have you heard me allude to it before—the greenmail situation. If we acknowledge that there not only is the potential for abuse for both sides, but there have been taking place instances where the situation has been abused and we have seen abuses, why not legislation? What damage, if any, would you see as a result of congressional effort?

Last year, this committee voted out and we passed in the Senate legislation dealing with greenmail. I think anything over 3 percent and a shareholder who did not hold it for at least 2 years would be precluded.

Why not? What damage, if any, does that do to the system, and does it thwart legitimate takeover attempts?

PRECLUSION OF GREENMAIL

Mr. WRIGHT. Mr. Chairman, I would agree with Chairman Shad when he said that greenmail does provide an additional incentive for possible investment in takeover attempts. If you preclude any form of greenmail at all, you are just simply taking one more factor out of the equation for return on investment by those investors who want to participate in the takeover.

From a more practical standpoint, though, and less philosophical, I would be concerned as to whether or not it would be possible to legislate against greenmail in an effective way and to also respond to market developments. There are new devices that are being generated every single day.

Last year's definitions in S. 2851 probably would not have picked up a couple of the more notable examples of greenmail. For example, I question whether or not the Phillips and Boone Pickens situation would have been covered by that definition, and I also know that the Cheseborough-Ponds and the Mr. Ichan situation would not have been covered by that.

There are many different ways for a greenmail situation to occur. It does not necessarily mean just mean an above-market value repurchase of the stock from a shareholder who has owned 3 percent for less than 2 years.

Third, corporate charter amendments prohibiting greenmail payments are being adopted, and stockholders do have the right to prevent greenmail if they so desire.

In addition regarding the application of the business' development rule, there are two recent decisions, in the Second Circuit Court of Appeals, and one case in the Delaware Supreme Court that suggest more stringent application of the business judgment rule in takeover situations. So you have quite a bit of action taking place in this greenmail area.

But the most important thing, I think, is that it would be very difficult to legislate against exactly what you are trying to prohibit without also affecting those areas that you are not trying to touch.

Senator D'AMATO. Let's take last year's bill, for example, and examine it. As you said, it would not apply in certain instances, those instances where, for example, the ownership of a certain percentage of stock had been in—been with the raider for 2 years, and I think that is in several of the cases that you cited.

Well, we are not attempting by way of this legislation to stop takeovers. I don't think that is anybody's intention here. But we are trying to stop the quick fix, the quick buck, where people just acquire a block of stock, and threaten the corporation for the specific purpose of being paid *x* numbers of dollars.

Mr. WRIGHT. I understand your concern and appreciate it, Mr. Chairman, in this area.

By the way, Mr. Ginsburg would like to just add one comment.

Mr. GINSBURG. Mr. Chairman, in the situation addressed by S. 2851 in the last Congress, the triggering events were very specifically laid out, repurchase of shares from a share owner under the circumstances Mr. Wright described, an owner for less than 2 years, and so on.

The intent in a greenmail transaction—if we can use that term loosely for now—is for management to confer value, to confer a benefit on a shareholder, or perhaps a nonshareholder, in return for that party's going away rather than proceeding with a tender offer.

Senator D'AMATO. Correct.

Mr. GINSBURG. Value can be conferred in any number of ways. In the Phillips transaction, Mr. Pickens was offered a cash amount that was actually slightly below market price in return for his interest in Phillips, this wouldn't have constituted greenmail within the meaning of S. 2851.

But more importantly, if the threat is credible, management may find any number of ways, depending on the circumstances and the legal inhibitions that may be enacted, to confer value on someone in return for going away. They may agree to have the corporation, the target corporation, enter into a long-term purchasing contract with a company, a supplier, owned by the greenmailer, if you will. They may extend a consulting contract.

There may be any number of ways to move millions of dollars from the target company to the putative greenmailer.

Senator D'AMATO. I am going to have to get my ranking member to focus in on this so that when we draw this legislation for this next session, we can take it, Bill, the things that Mr. Ginsburg rightfully points out, that maybe we don't prohibit.

You are saying that we can confer value, not only by the repurchasing of the stock but in other ways in terms of that greenmail, and I can't help but think that maybe—and I am appreciative of what you bring out, that if we don't cover it specifically under the proposed legislation, that we do something to cover it—because I can't think why that should be continued. I don't see any socially redeeming feature, any business feature that adds anything to our economy in permitting that kind of activity.

Mr. GINSBURG. Mr. Chairman, while I would be happy to advise on the drafting——

Senator D'AMATO. Could you address yourself to that——

Mr. GINSBURG. Yes.

Senator D'AMATO [continuing]. To my last statement?

Mr. GINSBURG. Yes, sir.

First, let me say that I don't think that any amount of attention to careful drafting will enable the legislature to anticipate all such situations——

Senator D'AMATO. Was there anything of value?

Mr. GINSBURG [continuing]. Except by some very general norm.

Senator D'AMATO. Sure.

Mr. GINSBURG. Exactly.

Now, those general norms will ultimately be applied by courts who will determine whether in a particular case the contract—the consulting contract, the supply contract, what have you—was indeed greenmail in contravention of the norm or was in fact a bona fide business relationship.

It is my understanding of the current state of the law presently on the books; that is to say, the State corporation laws——

Senator D'AMATO. You mean the business judgment rule?

Mr. GINSBURG. Well, the business judgment rule is a good enough shorthand for the relevant body of law here—that managements are indeed not supposed to and cannot lawfully enter into such contracts in order to entrench themselves rather than to serve the interest of the company.

Senator D'AMATO. The local courts have made a mockery of the interpretation, and that is one of the great problems that we have. The State courts have done an absolutely almost scandalous job of protecting shareholders.

Mr. GINSBURG. I think it is true that the business judgment rule has been a very weak prophylactic, historically. It is also true, however, that in the last 2 years, at most, since these transactions have become prominently featured——

Senator D'AMATO. Ginsburg is good. Let me ask you something. Your background, are you an attorney?

Mr. GINSBURG. Yes, sir, I am a professor of law at Harvard University, on leave to the administration.

Senator D'AMATO. Well, it comes through. We are lucky to have you.

Mr. GINSBURG. Thank you, Senator. [Laughter.]

I am happy to discuss these things with you.

Senator D'AMATO. I mean, but how do they give you this title, Professor, Administrator, Office of Information and Regulatory Affairs?

Mr. GINSBURG. Mr. D'Amato, I think we have some experience now with going in and out of Italian. That is a farmissher; that is, it is a confusing title.

Senator D'AMATO. Yes. I thought you were the public relations director. [Laughter.]

Please.

Mr. GINSBURG. In these recent——

Senator D'AMATO. I didn't mean that to be disparaging.

Mr. GINSBURG. I understand.

Senator D'AMATO. I am talking about in terms of your performance here it is obvious that we have got to get that title changed, Joe. [Laughter.]

Mr. GINSBURG. Thank you.

NOTORIOUS GREENMAIL CASES

In recent years, these notorious greenmail cases—and they really have become prominent only since 1983—have resulted in literally scores of shareholder suits being filed around the country.

There were seven prominent cases last year that were featured in an article in Newsweek, and so I followed up on them to see what happened. Well, there were 53 individual and class actions filed against the seven companies involved.

Now, not a single one of those 53 cases has gone to judgment. Some were settled, most are pending. There have been two recent cases that bear on this.

One, the *Norlin* case in the Second Circuit Court of Appeals, the Federal court in New York, applying New York law, found that valiant efforts made by management to entrench itself in that case using an ESOP and other sidesteps, rather than greenmail itself, in fact violated the management's duty of loyalty to its shareholders. The court suggested that where the management is acting—I am sorry to say that in one place it said "primarily" and at another place it said "solely"—to entrench itself, then it bears the burden of showing that its transaction was in fact fair to the shareholders. That is a new development.

In the Delaware Supreme Court, we have a recent decision in which a management which seemed to be hurrying to accept a friendly takeover offer and therefore refused to investigate an offer made by another group that was interested in a higher price, failed in its duty to shareholders to try to get the highest price for the company.

I think that the events of the last couple of years that have properly gained the attention of this subcommittee have also made an impression on the courts, and I think Mr. Wright's point is not that greenmail should be tolerated on the grounds that it is socially useful, but rather that it is difficult to get at except on a fact specific basis. It appears that the courts are now engaged in literally dozens and scores of cases trying to do that, and in our view, since they have succeeded over the decades in responding to new corporate transactions, new challenges, it is appropriate, before taking a step in this direction, to see whether in fact the courts don't deal adequately with these cases.

Senator D'AMATO. Would you comment on that which I have raised with others of our witnesses, the kinds of defensive tactics that I think are basically abhorrent and really violate stockholders' rights?

Mr. GINSBURG. I am sorry, which other tactic, sir?

Senator D'AMATO. The kinds of tactics taken, defensive tactics——

Mr. WRIGHT. Are you talking about tactics like poison pills?

Senator D'AMATO. Yes, that I think are again no value other than—no redeeming value other than to provide entrenchment for the management.

Mr. GINSBURG. Defensive tactics that have not been ratified by shareholders ——

Senator D'AMATO. Well, I didn't bring up with my good friend Chairman Shad, but you know, it is not the most difficult thing to

get the shareholders to undertake, when you send them volumes of materials and you are able to vote proxies because you have large institutional holdings and are able to get their consent, even to disenfranchise themselves on their voting rights. I mean, we understand that.

Mr. WRIGHT. Well, Mr. D'Amato, I am not certain that I agree with that.

Senator D'AMATO. It is taking place.

Mr. GINSBURG. About half of the shares traded on the exchanges are owned by institutions. Many of them are fiduciaries. Many of them are investing pension moneys and other kinds for which they have a fiduciary obligation to vote in the manner that best serves the interests of their ultimate beneficiaries. If they are not doing so, they are violating State law, possibly ERISA as well, and the subcommittee should proceed to determine whether in fact that is the case.

But, I don't think we need to take it as a given that they are in fact betraying the trust with those moneys.

Mr. WRIGHT. Mr. Chairman, I would say it is becoming more difficult to get shareholder votes in areas where it could be perceived that it will reduce the return that they may get from their investment.

Senator D'AMATO. Not the return, we are talking about corporate governance. We are talking about a situation where you heard Chairman Shad testify, that 400 of the 500 companies have engaged in this kind of activity. Doesn't that disturb you?

Mr. WRIGHT. It disturbs me to a certain extent, but it all depends upon what activity you are talking about. As you know, there is not consistency, across the board, of what amendments are being made to these charters.

I would add one more thing to the greenmail discussions that we just finished with, and that is that the charter amendments that are occurring at the present time regarding greenmail have widely differing threshold levels. Now, in the legislation last year, as we mentioned, it was 3 percent. They are ranging all the way from 1 up to 5 and 6 percent. So this is one of the problems you have of trying to establish a pattern that would fit across every single corporation regardless of the industry they are in, the financing involved, or their particular characteristics.

CORPORATE CHARTER AMENDMENTS

It bothers me a little bit that you see many of these corporate charters being amended in many of these areas. It does not bother me when I see them being amended by the stockholders in the areas of greenmail, poison pills, and a lot of the defensive tactics.

Mr. GINSBURG. The large numbers, or the 400 to 500, 600, corporations to which Mr. Shad referred, I believe, reflects many much weaker provisions as well, such as adopting staggered boards and supermajority requirements for the approval of a tender offer, which do effectively increase the board's bargaining power in entertaining a hostile takeover.

Senator D'AMATO. Let me pose a question—and my time is up, but with the deference of my colleagues—it just seems to me that

when we have an area where the New York Stock Exchange for the first time in Lord knows how many years is considering, and probably being pressured into a situation where the old traditional rule of one share one vote, be changed and that they be permitted to move away from that, that we had better understand that this is more than just a simple matter of using a defensive technique.

I am not against mergers and acquisitions. I don't think anybody here has expressed that, but some of the abuses by both those who seek to take over, the "raiders", and those who seek to employ defensive techniques and when, Professor, we are relegated to say, well, let's wait for the State courts which heretofore have been for the most part silent in addressing these, and it takes years, and you put stockholders, the little stockholder who has little, if any, money to a terrible test to seek equity. And they may have to depend on some group who will or won't decide to take a particular action, some group who may have their interest compromised by way of court settlement.

And you mentioned you have checked 52 cases, I believe, and you said to date none has come to final judgment. I think that is proof positive of my point, that to let people be out there, stockholders, in such a vulnerable position, shouldn't Congress look at this very carefully?

I am not rushing to judgment on it, but I say there is something that certainly disturbs this Senator about what I consider to be an abuse, and, you know, simply to say let the courts and let the States undertake this when I think maybe the NASD, the New York Stock Exchange, as well as the American Stock Exchange should do something in the self-regulatory area lest we do it.

Mr. GINSBURG. Well, of course, the rules of the exchanges are supervised by the SEC.

Senator D'AMATO. Well, you heard me pose that question with respect to Chairman Shad, a section 19(c) proceeding. I hope they are going to consider that.

Mr. GINSBURG. As to matters beyond the stock exchange rules, though, such as direct intervention by the Federal Government and the relationship between shareholders and their corporations, our view is that if there is a market failure of national proportions, then the Congress should be figuring out appropriate steps to address such a matter. That is a formulation, by the way, that Chairman Shad used last year—but we are far from seeing anything like that in the activity that you have described thus far, although we can agree that there are abuses out there and we are still waiting to see whether the courts will deal with them adequately.

We don't know the answer to that. We just don't have that sort of a market failure on our hands.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Mr. Wright, in Sunday's Washington Post, the lead story in the business section outlined the problems confronting the empire of Miami-based financier Victor Posner. The Post stated, and I quote,

> For the better part of two decades the Wiley Posner has been the premier corporate raider of corporate America gaining control of 40 companies and striking fear into the heart of managements of dozens of others.

The article outlines how all of the companies are intertwined with one company's stock acting as collateral for the debt of another company. The tone of the article raises the spectre that his billion dollar empire is a house of cards that could be waiting to come down.

Now, shouldn't we be concerned that it's not in the best interest of the country or in the best interest of our economy to permit these highly leveraged conglomerates to be so easily taken over, or to take over American business against the judgment of their board of directors.

Isn't this reminiscent of the problems associated with the pyramidal utility holding companies of the 1920's?

Mr. WRIGHT. No, sir, Senator. I don't think it really is equivalent. First of all, there's a whole series of new regulations that have come out that apply regardless of what the leveraging is.

And, second, I think that our financial institutions, that are providing funds to these organizations are much more sophisticated.

Without specific reference to that situation—I did read the article and I saw the spaghetti chart with all the various ownerships—I would say that if you try to get into any area where you are controlling how you're going to own various minority and majority positions within corporations, how you're going to finance it, and then try to establish what you could use as collateral for additional leveraging, you would be in an unending maze of extremely complex legislation, and regulation that you wouldn't be able to handle.

At this particular stage, I understand that that situation is, you know, if you read the Post and you believe what you read in the Post, mildly shaky and my guess is that you're going to have to find some shaking out occurring within that organization, if that's true.

But I would not suggest, by any means, that we would try and legislate to prevent that type of situation or that we would compare it to the early 1920's.

Senator PROXMIRE. Well, the legislation that I have introduced and all the legislation I know about wouldn't even touch in any way friendly takeovers. For hostile takeovers, I provide that the bidder must first get a two-thirds vote of all the shareholders.

So, we're not talking about a situation in which we would stop mergers or stop people from investing or buying companies if they wanted to do so.

Mr. WRIGHT. Senator, again with all due respect, I think S. 706 would make it extremely difficult to conduct any corporate takeovers and would place hurdles in the way of any interested parties.

Senator PROXMIRE. Any corporate takeovers? As I say, we don't touch friendly takeovers. If the board of directors has no objection there's no change in the present law, none. If the board of directors does have an objection it would require that two-thirds of the stockholders vote that the tender offer be submitted to the stockholders. If they vote for it, then the bidder has an opportunity to acquire a majority of stock.

Mr. WRIGHT. But then again, how do you define a hostile takeover, because in many cases ——

Senator PROXMIRE. Well, a hostile takeover is where the board of directors agree.

Mr. WRIGHT. Well, in many cases, though——

Senator PROXMIRE. See, the outside members of the board, not the members.

Mr. WRIGHT. I'm aware of that.

But in many cases, we've shown where there's been a hostile takeover attempt and in half of all the cases where they did resist it, they got a higher premium for their stockholders.

Senator PROXMIRE. Is that necessarily good?

Mr. WRIGHT. I think it's very good. That's part of the normal negotiating process that you go through between the bidder and the target company.

Senator PROXMIRE. If you're a stockholder it's great, but on the other hand there's no evidence that paying that much more and going into debt that much does anything for the productivity of our country or creates any kind of greater wealth or greater value in our country.

HIGHER PREMIUMS GENERATE WEALTH

Mr. WRIGHT.I don't agree with that, Senator. I believe that if you do have higher premiums, a higher stock price, it generates wealth. If nothing else it might bring in funding from outside sources outside this country which, as you know as well as I do, is happening at record levels right now.

But what you'd be doing also in S. 706, I feel, is you would be taking away part of the leverage that the bidder has in being able to negotiate a higher price. What they would have to do is they would have to establish exactly what their intent is toward the bid that is being proposed. And in many cases, that is not in the interest of the corporation or that is not in the interest of the corporation's stockholders.

Senator PROXMIRE. The Reagan administration believes that hostile takeovers are generally beneficial. What evidence is there to support that?

Mr. WRIGHT. A number of stock price studies have been conducted and we can identify those for the record.

Senator PROXMIRE. I wish you would provide that in full.

Mr. WRIGHT. I'd be happy to.

What the studies found was, by overwhelming evidence, that takeovers are beneficial to the economy whether they be hostile or whether they be friendly.

Now, I understand that there is one study that reaches other conclusions that is based upon, accounting data. We didn't think that it had the same credence as the stock price studies.

Senator PROXMIRE. Can you cite several examples of hostile takeovers that you believe have been beneficial to the country. Of course, they're always beneficial to the stockholders who sell. But I am looking for examples of takeovers that create a situation where there is more research, more development, better products, et cetera.

Mr. WRIGHT. Or it could be efficiency of scale where you have the company that takes over is able to substantially reduce the combined overhead—I think this is happening in some of the oil companies. Or you may have a situation where a company that's very heavily interested in real estate is using those assests for retail outlets.

Senator PROXMIRE. Well, for the record, what I'd like to have if you could provide it, is the specific examples of this with the names of the company, if you could provide that, where it has been beneficial to the economy.

Mr. WRIGHT. All right, Senator, I'd be happy to.

[Response to Senator Proxmire's question follows:]

RESPONSE TO SENATOR PROXMIRE'S QUESTION
FROM

JOSEPH R. WRIGHT, JR., DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

OMB personnel and personnel from the Council of Economic Advisers reviewed numerous economic studies before concluding that "virtually every recent empirical research study demonstrates takeover attempts are good for investors and the economy in general." The results of many of the studies reviewed by OMB and CEA personnel are summarized in:

Bradley, The Economic Consequences of Mergers and Tender Offers, 1 Midland Corporate Financial Journal 17 (Winter 1983);

Easterbrook & Jarrell, The Economic Evidence About Tender Offers, Appendix to SEC Advisory Committee on Tender Offers, Report of Recommendations, 107-121 (July 8, 1983) (Reprinted in Fed. Sec. L. Rep. (CCH) Special Rep. No. 1028, July 15, 1983);

Halpern, Corporate Acquisitions: A Theory of Special Cases? A Review of Event Studies Applied to Acquisitions, 37 J. Finance 299 (1983);

Jarrell, Do Acquirers Benefit from Corporate Acquisitions? (Univ. of Chicago, 1983);

Jensen, Takeovers: Folklore and Science, 84 Harvard Bus. Rev. 109 (Nov.-Dec. 1984);

Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983).

Together, these studies contain references to more than 100 published works. For your convenience, copies of these articles are enclosed.

These studies conclude, among other things, that "corporate takeovers do not waste resources; they use assets productively."

Jensen, supra, at 110. They also find that "the targets of successful tender offers and mergers earn significantly positive abnormal returns...," Jensen & Ruback, supra, at 15; "acquirers receive large and statistically significant ... returns from mergers and public takeovers," Jarrell, supra, at 22; and that "the results of both merger and tender offer studies are generally consistent with value maximizing behavior on the part of bidding firms." Halpern, supra, at 314.

The studies reviewed in these articles rely primarily on analyses of variations in stock market prices. The results of other studies that rely primarily on accounting data are, in comparison, less conclusive about the costs and benefits of merger and acquisition activity.[1] Nonetheless, these accounting data studies do not refute the consistent and overwhelming financial market evidence that the gains resulting from takeovers "do not appear to be simple wealth transfers" from bidders to targets. Jensen and Ruback, supra at 23.

Instead, the wealth gains resulting from takeovers reflect the market's anticipation that the takeover will lead to improved economic and financial performance. Frequently mentioned sources of gains include "reductions in production or distribution costs, often called synergies [that] could occur through realization of economies of scale, vertical integration, adoption of more efficient production or organizational technology, increased utilization of the bidder's management team, and reduction in agency costs by bringing organization-specific assets under common ownership." Id. (footnote omitted)

In addition, as explained in testimony before the Subcommittee, a takeover that leverages a target firm's assets and distributes a premium to the target's stockholders can promote efficient reallocations of investment capital from companies that do not have attractive, internal investment opportunities to ventures that offer more competitive returns. These benefits are not merely private gains that are captured by stockholders of bidder and target companies, Instead, these gains reflect a more efficient allocation of financial capital and productive resources that, in the aggregate, is beneficial for the economy as a whole.

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1 For reviews of accounting-based studies that attempt to evaluate the effects of mergers and acquisitions and of changes in industrial concentration see, e.g., Benston, The Validity of Profits-Structure Studies with Particular Reference to the FTC's Line of Business Data, 75 Amer. Econ. Rev. 37 (1985) (hereinafter cited as "Benston LB Study"); Benston, Conglomerate Mergers, (American Enterprise Inst. 1980); P. Steiner, Mergers (U. Mich. Press 1975).

When evaluating studies of merger and acquisition activity, including takeovers, it is important to recognize that studies that rely on accounting data are often "seriously compromised" because they "do not provide information on the expected long-run impacts of the acquisition on the participants; there are serious problems in defining a comparable control group; and the comparison group does not provide information on how the specific firms would have performed without the acquisition." Halpern, supra, at 299. For example, a recent analysis of the accounting data collected in the Federal Trade Commission's Line of Business Database ("LB Data"), the most extensive existing database of accounting information that purports to be related to measures of economic performance, concludes that LB Data are "of doubtful value for the purposes of economic analysis."[2] This study concludes that, "[T]he numbers reported, which are derived from the companies' accounting system, do not reflect economic market values well."[3] The study also finds that the LB Data impart biases that are not randomly distributed, and therefore yield "measured, though invalid, relationships among the variables that purport to reflect the economic performance of companies in markets."[4]

In contrast to the extensive controversy surrounding the interpretation of studies based on accounting data, the results

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[2] Benston LB Study at 64. The Benston LB Study is not alone in its criticism of studies based on accounting data. For example, another recent study concludes that "Economists (and others) who believe that analysis of accounting rates of return will tell them much (if they can only overcome the various definitional problems which separate economists and accountants) are deluding themselves." Fisher & McGowan, On The Misuse of Accounting Rates of Return to Infer Higher Monopoly Profits, 73 Amer. Econ. Rev. 82 (1983). This article drew a vigorous response. See, The Misuse of Accounting Rates of Return: Comments and Reply, 74 Amer. Econ. Rev. 492-517 (1984). For further criticisms of studies based on accounting data, see, e.g., Schwert, Using Financial Data to Measure Effects of Regulation, 24 J. Law & Econ. 121, 128 (1981) ("[T]here is no stable function which relates the market value of the firm to accounting data, such as earnings or book value."); Ayanian, Advertising and Rate of Return, 18 J. Law & Econ. 479 (1975); Liebowitz, What Do Census Price-Cost Margins Measure?, 25 J. Law & Econ. 231 (1982); Salamon, Accounting Rate of Return, Measurement Error, and Tests of Economic Hypotheses, Amer. Econ. Rev. (forthcoming, 1985).

[3] Benston LB Study, at 64.

[4] Id.

of which are, in any event, mixed,[5] the results of studies based on capital market data are remarkably consistent, both as a matter of economic theory and empirical evidence.

Indeed, "[t]here is no other proposition in economics which has more empirical evidence supporting it than the efficient market hypothesis.[6] Although there are certain anomalies in the evidence supporting the efficient market hypothesis,[7] "numerous studies demonstrate that the capital market responds efficiently to an extraordinary variety of information."[8] The frequently voiced criticisms that capital market studies are short term, or that the market is inefficient, are simply incorrect. The results of the capital market studies are supported by research spanning ten year time periods, and the evidence that market prices promptly reflect publicly available information in an unbiased manner is voluminous.[9] Instead, these criticisms

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[5] For example, numerous studies based on accounting data suggest that larger firms tend to be more efficient than smaller firms. See, e.g., Lustgarden, Productivity and Prices: The Consequences of Industrial Concentration (AEI 1984) ("[I]ncreases in productivity are greater and price increases are smaller where concentration has increased." at 32); Peltzman, The Gains and Losses from Industrial Concentration, 20 J. Law and Econ. 53 (1977) (The cost reducing effects of concentration more than offset any profit-raising effects, so the net result of higher concentration is lower prices.); Weiss, Optimal Plant Size and the Extent of Suboptimal Capacity, in Essays in Industrial Organization in Honor of Joe S. Bain, ed. Robert Masson and David Qualls (1976); Brozen, Concentration, Mergers, and Public Policy (1982) ("[R]estraints on large firm growth imposed by public policy in the United States probably have restrained productivity growth." Id. at 13.)

[6] Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 551 (1984), quoting Jensen, Some Anomalous Evidence Regarding Market Efficiency, 6 J. Fin. Econ. 95 (1978).

[7] See, e.g., the articles cited in Gilson and Kraakman, supra note 8, at 551, n. 10.

[8] Gilson & Kraakman, supra note 8, at 551.

[9] Capital market studies extending over a ten year period are consistent with the shorter event study analysis. See, Dodd & Ruback, Tender Offers and Stockholder Returns, 5 J. Fin. Econ. 351 (1977). For an examination of the current state of research supporting the efficient market hypothesis, including a lucid explanation of the meaning of market efficiency as well as a discussion of the mechanisms that sustain market efficiency, see Gilson and Kraakman, supra note 8.

display a lack of familiarity with the techniques and findings of the capital market studies.

Furthermore, the analyses relied upon most heavily by OMB and CEA are drawn from a class of "event studies" that do not depend on the efficient market hypothesis for the accuracy of their results or validity of their interpretation. These event studies assume only that the level of market efficiency does not change suddenly and systematically just before or after the announcement of a takeover.[10] These studies do not presume or require any given level of market efficiency for the validity of their results, and not even the harshest critics of the efficient market hypothesis claim that sudden and systematic shifts in the level of efficiency occur in conjunction with takeovers. Accordingly, the results of these "event studies" are, by a wide margin, the best available economic evidence regarding the costs and benefits of takeover activity.

Because of the fundamental difficulties inherent in the use of accounting data the weight of currently available economic evidence is most properly drawn from capital market and event studies. The 1985 Economic Report of the President describes the relative merits of studies that rely on these data:

> Ideally, a study of the costs and benefits of takeover transactions would evaluate the gains and losses resulting from each transaction on a case-by-case-basis. In addition, each takeover transaction would be evaluated by objective and well-informed observers with strong incentives to render accurate and unbiased estimates of each transaction's likely consequences. Such an evaluation would also look behind the accounting techniques and book values employed by the parties, and would arrive at an assessment based on current market values and best estimates of future market trends.
>
> In many ways, the behavior of prices quoted in the stock market provides just such an evaluation of the probable consequences of a takover transaction. In the stock market, each takeover transaction is evaluated on its own merits by investors who, because they stand behind their assessments with real dollars placed at risk, have a powerful incentive to judge

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[10] For further explanation of this point see Brown & Warren, Measuring Security Price Performance, 8 J. Fin. Econ. 205 (1980); Schwert, Using Financial Data to Measure Effects of Regulation, 24 J. Law & Econ. 121 (1981); Cragg & Malkiel, Expectations and the Structure of Share Prices (1982); Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983).

> accurately the outcome of individual takeover transactions. It is also well established that the stock market sees through accounting techniques and bases its evaluations on underlying market values. Moreover, there is extensive evidence that the stock market rapidly absorbs any information contained in historic price patterns of stock trades. Therefore, even if the stock market goes astray in its assessment of the likely consequences of takeover transactions, such deviations would give rise to arbitrage opportunities that would return the market to a more unbiased and objective perspective. The market's evaluation of takeover transactions is therefore self-correcting over time.
>
> Stock market prices thereby provide a reliable barometer of the likely consequences of takeover transactions. If the aggregate net change in the value of acquirers' and targets' shares is positive as a result of a takeover, then the transaction creates wealth and is beneficial. If the aggregate net change is negative, the transactions reduce wealth and are harmful.

The Market for Corporate Control, Chapter 6 in The Economic Report of the President 196-97 (1985).

A study was recently prepared for the Federal Trade Commission by F.M. Scherer and David Ravenscraft (the "R-S Study") that is based entirely on LB accounting data and may well suffer from the problems discussed above. The R-S Study may therefore represent a "continued sophisticated misuse of biased and irrelevant data...."[11]

Even if the results of the R-S Study are accurate, however, those results do not necessarily contradict the conclusions drawn from the capital market analyses. The R-S Study finds that profitability is "higher in lines of business that have sustained important levels of merger activity."[12] This finding is consistent with the view that, on average, mergers and acquisitions add economic value to the combined enterprise.

The R-S Study also finds that "when account is taken of the premiums paid by the acquiring firm, reflected in higher purchase-merger asset basis and depreciation flows, the net

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11 Benston LB Study at 65.

12 R-S Study at 21.

profit effect for acquirers turns from positive to negative."[13] This finding may be explained as an artifact of the underlying accounting database. For example, if an acquiring company depreciates acquired assets at a rate that exceeds the true rate of economic depreciation, then the profitability of the acquisition, as reflected by accounting conventions, will be artificially depressed relative to true market values.

A simple example illustrates this point. Suppose a firm acquires assets for a price of $100 million and is able completely to depreciate those assets on its books over a 5 year period. Because of these depreciation charges, the acquirer's profits will be depressed by a total of $100 million over that 5 year period. However, if the real market value of the underlying assets has increased over that same five year period, then the acquirer can actually earn a profit when it sells the acquired assets on the open market. Nonetheless, the accounting techniques used in the R-S Study would conclude that this profitable acquisition has generated a net loss. This is but one of many examples of transactions in which the R-S Study could find accounting losses despite the fact that the underlying transaction is profitable and beneficial.

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[13] Id. at 22.

Senator PROXMIRE. Now, Professor Ginsburg, I know that you're a great believer in the free market as the way to allocate resources in our society and so am I. I know it as well that Preston Martin said that "leveraged buyouts typically entail as much as 80 to 90 percent debt financing." And that's been the general consensus of the witnesses we've had here.

As you know, interest payments on such debts are tax deductible so, in effect, our Tax Code gives us subsidy to leveraged buyouts thereby encouraging them.

Wouldn't you, as a free marketer, favor the discontinuation of such a subsidy that skews market behavior?

Mr. GINSBURG. The tax deductibility of interest seems to me something that should be examined apart from the purpose to which the credit is put in any particular instance, as I think Chairman Shad suggested earlier today.

The deductibility of interest raises a lot of tax policy issues that should not be focused on this very peculiar example of leveraged buyouts. I have 80- to 90-percent debt on my home, as well, in the form of a mortgage.

Senator D'AMATO. Is that your second home, Professor? [Laughter.]

Mr. GINSBURG. Mr. D'Amato, my second home is 100-percent debt financed, because I couldn't afford it.

Senator D'AMATO. Boy, you're going to be in big trouble soon.

Senator PROXMIRE. You're a distinguished professor at Harvard with a very solid income, assured for years, you're a brilliant man, you'd have no trouble—most really, distinguished professors as you are in economics make a whale of a lot more on the outside. You have no problems.

But if you're a typical corporation in this country and you recognize that nobody's repealed the business cycle and you have down periods when your income drops, I can envision a situation where we're going to have a very tough time in the next few years if we have another deep recession.

You won't but the many corporations will.

Mr. GINSBURG. The debt-to-equity ratio of American industry has varied over time from decade to decade and it varies from one sector of the economy to another.

It has been decreasing slightly over the last several years for all industry taken together. It's decreased from 1981-84, from 62.1 to 58.5 percent.

Senator PROXMIRE. Well, that's right and I think that's a healthy increase in equity. But in some of these corporations that are being taken over, you have the reverse—or being threatened with a takeover, like Phillips.

As I pointed out earlier, you had a very healthy equity debt situation and now you have one that's considerably less healthy and it might be dangerous.

Mr. GINSBURG. It's certainly true that the statistics I read aggregate for the entire industrial sector of the economy, whereas, individual firms may be experiencing the changes you suggested.

If we look at the natural resource or fuel section of the economy, however, we find that the debt-to-equity ratio for that industry has decreased from 1981 through 1984, from 45.4 to 41.8 percent.

Now, not only has it decreased for that segment but that segment is still substantially less leveraged than American industry as a whole.

And in the transaction to which you alluded and others, we are seeing outsiders analyzing balance sheets and asset—physical assets—owned by major oil companies and determining that there is a lot of unused leverage there and that the company would be better off borrowing against it's assets—in some cases selling the assets off—and redeploying the proceeds in other ventures, either new exploration or diversification

That seems to me a normal process that ebbs and flows and one in which close monitoring by the Fed is important. But congressional legislation to establish an appropriate debt/equity ratio or maximum for any given company would be very untoward.

Senator PROXMIRE. I'm not suggesting that. Thank you, Mr. Chairman.

Senator D'AMATO. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Wright, according to Marty Lipton who testified yesterday, our tax laws and accounting conventions favor highly leveraged acquisitions and hostile takeovers, favor those over direct research expenditures and capital investments.

He also said that the ability to capitalize and defer the amortization of acquisition premiums makes takeovers more attractive from an accounting standpoint than research and development which must be immediately expensed.

NEUTRALITY OF THE TAX CODE

Now, I don't think Chairman Shad really answered Senator Cranston's question earlier here today. Does this administration favor a Tax Code which is neutral with respect to takeover activity?

Mr. WRIGHT. Yes, sir.

Senator SASSER. Well, that's a clear answer.

You referred earlier in your testimony to the inability of shareholders to receive full value for their holdings and the implication clearly was that management is generally at fault. Now, I would suggest the possibility that perhaps this is frequently a short-term phenomenon that shareholders can't get full value, that a stock may be temporarily devalued because management has, in fact, taken a more productive and more beneficial action on behalf of the company.

For example, I'm referring to the phenomenon of the drop in stock prices when a company announces long-range research and development plans. And I happen to think one of the problems in our economy now with regard to productivity and our increasing inability to compete on the international market, is that American business and our corporate structure has been too geared to the short-term profit-and-loss statement and too geared to short-term compensation for shareholders and not geared to the long-term approach, not looking to what's going to happen in 1995 and the year 2000 or even the year 1987, in some cases.

Now, doesn't current policy, with regard to takeovers, discourage the kind of long-range investment that companies should be encouraged to make, long-range investment in R&D, that's not going to immediately enhance the value of stock? As a matter of fact, it's going to diminish the immediate selling value of stock.

Are companies now looking too hard for immediate benefits and sacrificing long-term advancement and profitability?

Mr. WRIGHT. Senator, the correct answer is yes, some are and some are not.

Senator SASSER. Is this thing encouraged by the fear of hostile takeovers and of letting the value of their stock run down to some extent?

Mr. WRIGHT. First of all, let me say that I agree with Chairman Shad on the fact there has been a short-term outlook by management for a long period of time in this country. In part, that is forced by the requirements of the SEC and other organizations to report on a 3-month basis. It also has resulted in a situation in which in many cases companies actually give performance awards based on short-term performance, whether they be profit sharing or bonuses based upon those reports and that is a good, natural incentive to try to increase short-term profitability.

So, I do not believe that there is any unique phenomenon that has been exacerbated seriously by this recent—if you want to call it, spate—in takeover attempts. It has been there for some time, and, I think, has been a fundamental problem with the ability of this country to expand its capital base and invest properly in R&D.

Senator SASSER. Well, I think we can agree that the situation has not been helped by the recent spate of takeovers.

Mr. WRIGHT. It is never helped when you have to focus on the short-term. I would add that in some of these cases, if management would focus on the long-term to start with, rather than just the short-term, they would not be forced into these situations where they have somebody come up and believe that they can get a greater return on the deployed assets than the management has.

But I would like to add one more thing where I might disagree with the Senator. And that is that you're saying that the stockholders have not been rewarded by those managements who have been looking long term and particularly been investing in R&D.

Senator SASSER. I'm not saying—well, you go ahead and make your answer.

R&D ENHANCE FIRMS STOCKS

Mr. WRIGHT. OK. I'll make the answer and then we can discuss it. In the prepared statement on pages 16 and 17, we basically state that the Office of the Chief Economist of the SEC found that institutional investors which are, taking more and more of a prominent position in the ownership of these securities, favor firms that spend more on R&D; that firms that are takeover targets tend to be firms that have invested less in R&D than other firms; that firms that are takeover targets have lower institutional ownership than nontarget firms; and that stock prices increase when firms announce new R&D projects.

So, while I would agree with you that there is a short-term orientation by American management that has occurred for many years, I would disagree with the fact that there is not a premium or there is not a value that is recognized by the stock market in those firms who do take a longer term approach.

The interesting part about that statement and that finding from the Chief Economist, is that the takeover attempts appear to be going toward those organizations that have not been investing in longer term projects in R&D.

Mr. GINSBURG. Senator, if I may add just one point to that, it is that many new firms that come to the stock market for the first time emphasize in their offering prospectus the fact that they have never had earnings, perhaps never had sales, cannot project earnings for at least several years, and are doing nothing but R&D and will do nothing but R&D with the proceeds of the public offering.

People are willing to invest in activities of that kind and the stock market has demonstrated that it's there to fund, long-term as well as short-term activities, if they make sense.

Senator SASSER. Yesterday we heard from one of our witnesses, Claude Brinegar, of Unocal, that Unocal had become a raider's target, not because it was unsuccessful, but rather because it was successful. He pointed out that Unocal had been successful in finding oil at low cost and they'd been more profitable than most of their competitors and have provided better returns to their shareholders.

They kept their debt burden low and they invested heavily in R&D, in such important projects as geothermal energy and oil shale development.

Now, what is your reaction to the view of many that there's something seriously amiss in this Nation's financial system and in our tax structure when companies that are successful like this one, find themselves the targets of raiders and hostile takeovers?

Mr. WRIGHT. Well, Senator, if I may, I'd just like to read from an article that was in U.S. News and World Report, April 8, and I quote:

> The statement about Unocal, quote, that one individual who was in an investment firm felt that Unocal has such appealing characteristics that one wonders why Unocal was not Mr. Pickens' first venture. According to this individual and other analysts, Unocal's oil reserves are significantly understated. The company is capable of generating more than $400 million in excess cash each year. The value of Unocal's assets is estimated at $60–$65 a share versus a recent market value of about $46.

And it goes on and on and on. And so I would just say that by one individual, with a reputable firm, Unocal had basically put themselves into this position by not taking advantage of the leveraging power that the management may have had over the years.

Mr. GINSBURG. Mr. Sasser, if I may just add one point. I think that R&D is not necessarily a good thing. It depends on whether the R&D makes sense. And research into coal gasification and shale gasification when oil is selling at the pump at $1 a gallon is probably the very reason that they've attracted takeover attention and criticism of their management.

Coal gasification was projected to be viable when gas was at $1.50 in 1980 dollars, and most people have disinvested from that activity rather than pursued it.

Senator SASSER. You said earlier, Mr. Wright, that you favored a Tax Code that's neutral toward takeovers.

Governor Martin indicated a moment ago that he didn't think the current Tax Code was neutral.

Do you agree with that?

Mr. WRIGHT. Senator, I think, on the surface, the current Tax Code, as far as I'm concerned, is reasonably neutral. When you get into some of the more sophisticated areas such as handling of depreciation and ultimate investments that the bidder may look at, I really can't answer.

Now I would say one more thing. That is, I would be concerned about any changes in the Tax Code that would then favor the incumbent manager's ability to fight off any corporate takeover at the expense of those that might be interested in initiating the takeover.

At the present time, you can get the same deductions for massive leveraging by incumbent managers as well as for leveraged buyout deals. This is a long answer saying yes, on the surface, the Tax Code is reasonably neutral.

You get into these difficult areas of what are the other options for investment and how are those handled by tax.

Senator SASSER. My time has expired, Mr. Chairman.

Thank you.

Senator D'AMATO. Senator Sasser, if you have any concluding questions, because we are going to close the hearing——

Senator SASSER. I have no additional questions.

Senator D'AMATO. OK, fine.

Let me thank our witnesses, Deputy Director Joe Wright, and Professor Ginsburg, it was nice meeting you.

Mr. GINSBURG. Thank you, Mr. Chairman.

Senator D'AMATO. We will stand in recess with the intention of the committee, this chairman, to have three additional hearings after the recess to further explore this issue.

I might ask if we could look forward to calling you back, with a view toward looking at some specific legislation. I will probably send it to you so that we can get your comments on it. Your comments today as it related to legislative proposals that have been introduced in the past are deeply appreciated by the committee and by the chairman.

We stand in recess.

Mr. WRIGHT. Thank you, Mr. Chairman.

[Whereupon, at 12:25 p.m., the hearing was adjourned, subject to call of the Chair.]

IMPACT OF CORPORATE TAKEOVERS

THURSDAY, JUNE 6, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 9:05 a.m., in room SD-538, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Hecht, Gramm, Cranston, Sasser, Riegle, and Proxmire.

Also present: Senators Domenici, Metzenbaum, and Eagleton.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The Subcommittee on Securities will come to order.

This morning, the subcommittee is holding its third hearing on the subject of corporate takeovers. This topic continues to gain national attention, as each passing week brings more and more takeovers. In the last few weeks, we witnessed the resolution of the Mesa-Unocal contest, with Unocal remaining independent at a cost of several billion dollars and the largest merger in history outside of the oil industry, the $4.9 billion R.J. Reynolds-Nabisco merger.

The size and magnitude of these mergers demands that Congress focus on the implications of these activities.

In today's hearings, we will continue to focus on such issues as whether hostile takeovers provide a check on inefficient management, whether two-tier takeovers are coercive and prevent target shareholders from making a reasonable decision, whether action should be taken to eliminate multiple classes of stock with disproportionate voting rights, the role of high-yield corporate bonds in federally insured depository institutions in hostile takeovers, and whether the small investor is being driven from the equity market.

I'm hopeful that today's testimony will bring us a little bit closer to understanding a complex situation with broad social and economic ramifications.

I'd like to welcome all of the witnesses and thank them for taking the time to participate in today's hearings.

In our first panel, we'll have Felix Rohatyn, senior partner, Lazard Freres; and Frederick H. Joseph, vice chairman of the board and chief executive officer of Drexel Burnham Lambert.

Senator Proxmire, do you have an opening statement?

Senator PROXMIRE. No opening statement.

Senator D'AMATO. Senator Hecht.

Senator HECHT. No statement.
Senator D'AMATO. Senator Metzenbaum.

OPENING STATEMENT OF SENATOR METZENBAUM

Senator METZENBAUM. Mr. Chairman, I again want to compliment you for moving forward on this issue. Every day that passes without moving forward seems to create an extra and a new problem, not the least of which in this Senator's opinion, was the recent decision of the Delaware court. And without addressing myself to the merits or lack of merits of the parties in that particular matter, certainly as a former practicing lawyer, that decision strains one's credulity and also my legal imagination as to how they could arrive at the conclusion that they did.

I think that the fact that you had indicated at an earlier point your intention to mark up legislation in this area prior to the Fourth of July recess places you under an accelerated time procedure. But I can't think of many more important subjects that need to move foward with dispatch than this one.

I pledge to you my wholehearted support in your efforts to move this issue along and bring it to the floor in order that the Senate may deal with it very promptly.

I compliment you on bringing this hearing to this point and having such a distinguished list of speakers here this morning.

Senator D'AMATO. Thank you, Senator.

Why don't we start with Mr. Rohatyn. Felix, let me thank you again and first say that we have received your testimony. We will take it as if read in its entirety and you are at liberty to place whatever emphasis you want, on whatever part, be it all or part.

So why don't you proceed.

STATEMENT OF FELIX G. ROHATYN, SENIOR PARTNER, LAZARD FRERES & CO.

Mr. ROHATYN. Mr. Chairman, I'm happy to testify in front of your committee. My name is Felix Rohatyn and I am senior partner in the investment banking house of Lazard Freres, where I started my career 35 years ago. My work consists mainly of advising corporate clients as to financial matters in general, and mergers and acquisitions specifically.

I was governor of the New York Stock Exchange from 1968–72, and the chairman of its so-called crisis committee during those troubled years. I serve on the board of directors of five large New York Stock Exchange listed corporations and as chairman of the Municipal Assistance Corp. for the city of New York.

BROAD ASPECTS OF TAKEOVERS

Although there has been considerable attention paid to the junk bond phenomenon recently, I would like to consider the broader aspects of takeovers and the financing practices related to them. These issues are important to the integrity of the financial markets and to the proper functioning of the capital-raising system.

I have seen the evolution of mergers and takeovers from the conglomerate merger era of the 1960's, through the growing acceptability of large, hostile takeover bids during the 1970's, to the cur-

rent wave of huge transactions, with offensive and defensive tactics that often go beyond the norms of rational economic behavior. I am not here to argue against the ability of corporations to make acquisitions or to reject being acquired. Takeovers do not have to be friendly; they have to be fair and they have to be soundly financed. Current takeover tactics, both in the legal and financial area, run counter to those principles.

Arguments for new or additional regulation or legislation should be based on national interest issues. These issues involved here are twofold: First, the integrity of our securities markets; and second, the safety of our financial institutions.

They are both jeopardized by what is happening today as a result of excesses in connection with takeovers.

These excesses, let me hasten to add, are not limited to the takeover field. They are part of a general pattern of speculation in securities, commodities, currencies, et cetera. They are part of a trend of excessive risk taking on the part of financial institutions seeking performance at the expense of safety. They are the result of a climate of rapid deregulation with inadequate preparation as to the results in certain areas.

A series of events is eroding the climate of confidence required of our financial institutions. Among these was the financial collapse of several Government securities trading firms which led to crisis in the Ohio and Maryland savings bank systems. The financial collapse of Penn Square Bank which led to the quasi-nationalization of the Continental Illinois Bank and the demise of the Seafirst Bank, and the reported credit scares of Third World borrowers.

Every one of these events shakes the confidence needed by our financial system. They are, however, only the tip of the iceberg. Our banking system is still exposed to large risks. Many are under the illusion that the Third World debt problem has been resolved as a result of a series of rollovers; recent events in Argentina and Brazil with a combined external debt of $150 billion may create a rude awakening.

Elsewhere, if the price of oil were to drop by 20 percent, not unthinkable under present circumstances, the problems of banks with large energy loans would be compounded by the problems of large oil companies so elegantly restructured as a result of takeover raids and greenmail.

To this list, we have to add the dramatically increased use of debt, both conventional debt and junk bonds, in all types of takeovers and leveraged buyouts and the risks involved if we were to enter a serious recession. One does not have to be Cassandra to be concerned about the safety of our financial institutions and to their vulnerability to sudden jolts.

In the securities markets, especially in the takeover field, we also find troublesome excesses. Over the long run, the capital markets self-correct, but sometimes abuses become so widespread that the markets must be helped by legislation or regulation. Today, that is the case in respect to takeovers. The abuses fall into several general categories:

First, unequal treatment of shareholders as part of offensive or defensive corporate actions;

Second, unsound financial structures as a result of excessive leverage;

Third, destabilizing impact of large-scale arbitrage and other short-term trading activities as an integral part of mergers and takeovers.

I would like to examine each of these briefly.

First, the basic concept of our securities laws which have been the basis for the worldwide appeal of our securities markets, has been full disclosure, nonmanipulation, and equal treatment of all shareholders. The most basic elements of stock ownership, that is, equal voting rights and equal equity ownership for all common shareholders are now under attack. Both the techniques of current takeovers as well as concurrent court decisions undercut these concepts.

DETRIMENTAL TREATMENT OF SHAREHOLDERS

For instance, the New York Stock Exchange is under pressure to permit the listing of common shares with unequal voting rights; and the recent *Unocal* decision in Delaware permits, in certain cases, unequal payment among common shareholders.

In tender offers, two-tier takeover bids heavily favor professional traders to the detriment of nonprofessionals. Bids that are made subject to financing, in many cases directly or indirectly financed by junk bonds, permit the bidder to manipulate the markets without committing himself to purchase. The resulting activity by arbitrageurs and short-term traders create speculative accumulations which, in the parlance of the trade, put the company into play. Whether the result is greenmail or a white knight rescue, the result is a large profit for the raider, at minimal risk. The third-party, or white knight takeover, if it occurs, takes place purely to satisfy speculative positions taken as part of the raid.

Because of these tactics, defensive maneuvers have been devised that are equally damaging to shareholders. The payment of greenmail is the most obvious and, in many ways, the most old-fashioned of these maneuvers. Selective repurchase of stock, lockups, crown jewel options, shark repellent, and poison pills of one kind or another, all have been designed to enable managements and boards of directors to interpose themselves between the shareholders and takeover bids. These tactics have been used, sometimes indiscriminately, against bona fide bidders as well as against the more pernicious types.

In some of the more extreme cases, that is, in the defense of Carter-Hawley-Hale in the face of a 100-percent offer from The Limited and in the defense of Unocal against a partial offer from Mesa Petroleum, the courts permitted the target companies to selectively repurchase their own shares from some, but not all, shareholders.

The result, in many cases, is to find companies burdened with excessive debt and their remaining shareholders badly damaged. Phillips Petroleum, Unocal, Carter-Hawley-Hale are all examples of this type of operation.

Second, as a result of this activity, financial structures are seriously eroded. I have mentioned above several examples of compa-

nies which, in order to remain independent, have depleted their equity and taken on excessive debt. Several of the largest takeovers were brought about as a result of raids, financed by junk bonds, on the target companies which were then acquired by third parties. A large part of the oil industry has been badly damaged as a result.

Chevron-Gulf, Occidental-Cities Service, Mobil-Superior occurred as a result of raids or the threat of raids. The deterioration in their combined balance sheets has been dramatic. The premiums received by the acquired shareholders have been paid by the debt of the acquiring companies and, ultimately, by their shareholders.

Far from being a healthy restructuring, the oil companies involved are cutting exploration sharply, a practice our country will pay for dearly when the next energy crisis occurs.

In the meantime, as a result of their high levels of debt, they could be in serious difficulty, in the near term, if the price of oil continues to decline. If one were to write a scenario about how to get the United States into trouble as far as energy is concerned, it would be hard to improve on what is happening.

It is in the area of large takeovers that the junk-bond phenomenon is particularly hazardous. High-yield, unrated debt, in reasonable amounts, is a perfectly acceptable financing vehicle for many companies ineligible for investment-grade credit ratings. It is a different story, however, when this type of debt, in the billions of dollars, is used to substitute for equity in the takeovers of very large companies.

The risk in this type of operation is twofold. First, in the actual security of the paper. If the takeover is successful, the servicing of very high levels of debt, at rates of interest in excess of most targets return-on investment, requires significant asset dispositions which may not always be possible or desirable. It is an approach that also completely fails to take into account the fact that a large corporation is an entity with responsibilities to employees, customers, and communities, which cannot always be torn apart like an erector set.

The alternative to a breakup requires significantly improved operating performance which is very often much easier said than done. Indeed, in looking at many of these raids, one is left to wonder if the intent is really to acquire control or simply manipulate a third-party takeover in order to make a profit with little or no risk.

The second element of risk in this type of paper is liquidity. Much of this paper is privately placed, among a small group of private investors initially, and subsequently to financial institutions such as savings banks, insurance companies, and pension funds.

In many instances, no large-scale, liquid public market exists in these securities and purchases and sales are handled through private transactions. Many of the investing institutions are in financial sectors under considerable pressure at this time.

PROTECTION AGAINST TAKEOVERS

To protect themselves against this type of takeovers, companies have begun large-scale restructurings of their own whereby they assume significant amounts of additional debt in order to shrink

their equity and increase the price of their stocks. Arco and Litton Industries are the most recent example of this trend, the latter shrinking its capital base by more than one-third. Whether in the long run, this is sound financial policy and good for the country is open to question. It is highly probable, however, that these restructurings are driven more by the fear of these types of takeovers than by straightforward economic forces.

A new and potentially dangerous variation of this type of transaction is the transaction presently proposed by Turner Broadcasting Co. in its attempted takeover of CBS. This approach uses an exchange offer to offer junk bonds directly to CBS shareholders. The objective is to have a sufficiently active speculative market created for the bonds, either by listing on an exchange or otherwise, to induce CBS shareholders to take a quick profit and deliver control of the company to the bidder. A breakup of the company is inevitable since the bonds cannot possibly be serviced by the ongoing business.

This last approach can only be controlled if the SEC refuses to register bonds that do not meet certain minimum tests of viability and if the securities exchanges refuse to list them. This kind of junk bond takeover is a new device and should not be allowed to become another takeover abuse.

Junk bonds, of course, are not the only source of excessive leverage in recent takeover activity. Large-scale leveraged buyouts and going private transactions have been financed by bank and institutional loans in the tens of billions of dollars as well as by junk bonds. The result is more and more substitution of debt for equity and less and less stable financial structures.

Third, added to this combination of unequal treatment of shareholders and unsound financial structures is the market speculation which has become an integral part of the process. Very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools, incidentally, are financed by junk bonds. Very large pools of money are in the hands of raiders, similarly financed.

This creates a symbiotic set of relationships which has as its basic purpose the destabilization of a large corporation and its subsequent sale or breakup. It creates, at the very least, the appearance, if not the reality, of professional traders with inside information, in collaboration with raiders, deliberately driving companies to merge or liquidate.

The process is driven by the ability of raiders to make tender offers subject to financing, thereby avoiding costly commitment fees, and getting a free ride if they are bought out with greenmail or the target company is taken over by a white knight.

St. Regis Paper, Gulf Oil, Cities Service were forced to merge as a result of this process.

In summary, what does all this add up to?

First, at a time when we are trying to encourage long-term investment, this activity encourages speculation and short-term trading.

Second, at a time when we are trying to strengthen our important industries to make them more competitive, this activity weak-

ens many of our companies by stripping away their equity and replacing it with high-cost debt.

Third, at a time when our financial institutions—banks, savings banks, insurance companies—are under considerable pressure, this activity preempts more and more general credit and causes the weakest sectors to acquire large amounts of risky and possibly illiquid paper to show performance. Much of this paper has never been tested in a period of economic downturn.

Fourth, at a time when we need to continue attracting capital from all over the world, our securities markets appear to be more and more under the control of professionals and insiders. The rights and privileges of shareholders appear to be continually eroded.

STRINGENT REGULATION COUPLED WITH NEW LAWS

I believe that these issues are sufficiently serious to warrant the relevant regulatory authorities and the Congress to consider more stringent regulation coupled with new legislation.

To curb excessive use of junk bonds:

One, federally and State-insured and regulated financial institutions should be sharply limited in their ability to invest in obligations carrying below-investment grade credit ratings and/or lacking a bona fide public market.

Two, tender offers subject to financing should be prohibited as a manipulation of the public markets. Anyone making a tender offer should be required to have firm financing commitments in hand for 100 percent of the required capital.

To curb the excesses of takeover activity both on the part of bidders and targets:

One, any acquisition of more than 20 percent of a company's stock should require an offer for 100 percent at one price, unless it has the approval of the target's board.

Two, the minimum tender offer period should be extended to 60 days.

Three, shareholder approval should be required of the bidder's shareholders if the target represents more than 25 percent of the market value of the bidder.

Shareholder approval should be required of the target's shareholders if the target proposes to reacquire more than 5 percent of its shares, to issue or option securities having more than 10 percent of its voting rights, or to sell or option assets having a value of more than 10 percent of its market value.

And last, to maintain the integrity of stock ownership, we should:

First, eliminate any form of poison pill.

Second, delist companies with various classes of voting securities.

Third, eliminate shark repellents, staggered boards, fair-price amendments, and similar devices.

These actions should be part of a total package of legislation and/or regulation. They are all interconnected. It would be unreasonable to remove defensive devices such as poison pills from a company's use unless abusive takeover tactics were limited in a similar vein.

It seems to me that such an approach would be essentially neutral as to bidders or targets, subjecting all major corporate decisions to shareholder approval. It removes the need for hasty, and often exceedingly self-destructive, defensive actions and avoids the need to deal with the business judgment rule by making major corporate structural changes subject to shareholder vote.

In the area of excessive use of credit, whether junk bonds or otherwise, I believe that regulation as opposed to legislation can handle most of the problems. The SEC and its tender offer rules, the margin rules and the capital requirements set by Federal and State regulators of banks, insurance companies, and savings institutions, can deal with most excesses if the regulators decide to act or are directed to do so.

I have made a living, for more than 30 years, negotiating hundreds of mergers and acquisitions for a variety of corporate clients. Most of these were the result of negotiated agreements; some were bitterly contested, hostile takeovers. I hope to continue this activity for many more years.

I believe it to be an integral part of the service an investment banker should provide his clients and that it is an important and constructive factor in maintaining a competitive marketplace.

There is no question in my mind that thoughtfully negotiated mergers have a better chance of achieving their objectives than multibillion-dollar takeovers, or major restructurings, decided upon over a weekend, as a result of a raid.

Nonetheless, there should be room for many types of transactions in our market system, but very clear lines should be drawn between what is acceptable economic and corporate behavior on the one hand, and what is runaway speculation on the other.

That is not the case today.

There are always arguments against any changes. Regulation and legislation are, inevitably, imperfect and may, unwittingly, restrict perfectly valid activities. However, the integrity of our securities markets and the soundness of our financial institutions are vital national assets. They are being eroded today and regulatory and legislative actions are required to protect them.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

TESTIMONY BY FELIX G. ROHATYN, PARTNER, LAZARD FRERES & CO.

Mr. Chairman, members of the Subcommittee:

I welcome the opportunity of appearing before your Subcommittee. My name is Felix Rohatyn and I am a senior partner in the investment banking house of Lazard Freres, where I started my career thirty-five years ago. My work consists mainly of advising corporate clients as to financial matters in general, and mergers and acquisitions specifically. I was a governor of the New York Stock Exchange from 1968 to 1972, and the Chairman of its so-called "Crisis Committee" during those troubled years. I serve on the Board of Directors of five large New York Stock Exchange - listed corporations and as Chairman of the Municipal Assistance Corporation for the City of New York.

Although there has been considerable attention paid to the junk bond phenomenon recently, I would like to consider the broader aspects of takeovers and the financing practices related to them. These issues are important to the integrity of the financial markets and to the proper functioning of the capital-raising system.

I have seen the evolution of mergers and takeovers from the conglomerate merger era of the 1960s, through the growing acceptability of large, "hostile" takeover bids during the 1970s, to the current wave of huge transactions,

with offensive and defensive tactics that often go beyond the norms of rational economic behavior. I am not here to argue against the ability of corporations to make acquisitions or to reject being acquired. Takeovers do not have to be friendly; they have to be fair and they have to be soundly financed. Current takeover tactics, both in the legal and financial area, run counter to those principles.

Arguments are for new or additional regulation or legislation should be based on national interest issues. The issues involved here are two-fold:

a) The integrity of our securities markets;

b) The safety of our financial institutions;

They are both jeopardized by what is happening today as a result of excesses in connection with takeovers.

These excesses, let me hasten to add, are not limited to the takeover field. They are part of a general pattern of speculation in securities, commodities, currencies, etc. They are part of a trend of excessive risk-taking on the part of financial institutions seeking "performance" at the expense of safety. They are the result of a climate of rapid deregulation with inadequate preparation as to the results in certain areas.

A series of events is eroding the climate of confidence required of our financial institutions. Among these was the financial collapse of several government securities trading firms which led to crisis in the Ohio and Maryland Savings Bank Systems. The financial collapse of the Penn Square Bank which led to the quasi nationalization of the Continental Illinois Bank and the demise of the Seafirst Bank. The repeated credit scares of Third World borrowers. Every one of these events shakes the confidence needed by our financial system. They are, however, only the tip of the iceberg. Our banking system is still exposed to large risks. Many are under the illusion that the Third World Debt problem has been resolved as a result of a series of rollovers; recent events in Argentina and Brazil with a combined external debt of $150 billion may create a rude awakening. Elsewhere, if the price of oil were to drop by 20%, not unthinkable under present circumstances, the problems of banks with large energy loans would be compounded by the problems of large oil companies so elegantly restructured as a result of takeover raids and greenmail. To this list, we have to add the dramatically increased use of debt, both conventional debt and junk bonds, in all types of takeovers and leveraged buyouts and the risk involved if we were to enter a serious recession. One does not have to be Cassandra to be concerned about the safety of our financial institutions and to their vulnerability to sudden jolts.

In the Securities markets, especially in the takeover field, we also find troublesome excesses. Over the long run, the capital markets self-correct, but sometimes abuses become so widespread that the markets must be helped by legislation or regulation. Today that is the case in respect to takeovers. The abuses fall into several general categories:

a) Unequal treatment of shareholders as part of offensive or defensive corporate actions;

b) Unsound financial structures as a result of excessive leverage;

c) Destabilizing impact of large scale arbitrage and other short-term trading activities as an integral part of mergers and takeovers.

I would like to examine each of these briefly.

a) The basic concept of our securities laws, which have been the basis for the world-wide appeal of our Securities markets, has been full disclosure, non manipulation, and equal treatment of all shareholders. The most basic elements of stock ownership, i.e., equal voting rights and equal equity ownership for all common shareholders are now under attack. Both the techniques of current takeovers a well as concurrent court decisions undercut these concepts. For instance, the NYSE is under

pressure to permit the listing of common shares with unequal voting rights; and the recent Unocal decision in Delaware permits,in certain cases, unequal payment among common shareholders.

In tender offers, two-tier takeover bids heavily favor professional traders to the detriment of non-professionals. Bids that are made "subject to financing", in many cases directly or indirectly financed by junk bonds, permit the bidder to manipulate the markets without committing himself to purchase. The resulting activity by arbitrageurs and short-term traders create speculative accumulations which, in the parlance of the trade, "put the company into play". Whether the result is "greenmail" or a "white knight" rescue, the result is a large profit for the raider, at minimal risk. The Third-party, or "white knight" takeover, if it occurs, takes place purely to satisfy speculative positions taken as part of the raid.

Because of these tactics, defensive maneuvers have been devised that are equally damaging to shareholders. The payment of "greenmail" is the most obvious and, in many ways, the most old-fashioned of these maneuvers. Selective repurchase of stock, "lock-ups", "crown jewel options", "shark repellent" and "poison pills" of one kind or another, all have been designed to enable managements and boards of

directors to interpose themselves between the shareholders and takeover bids. These tactics have been used, sometimes indiscriminately, against bona fide bidders as well as against the more pernicious types. In some of the more extreme cases, i.e., in the defense of Carter-Hawley-Hale in the face of a 100% offer from The Limited and in the defense of Unocal against a partial offer from Mesa Petroleum, the courts permitted the target companies to selectively repurchase their own shares from some, but not all, shareholders. The result, in many cases, is to find companies burdened with excessive debt and their remaining shareholders badly damaged. Phillips Petroleum, Unocal, Carter-Hawley-Hale are all examples of this type of operation.

b) As a result of this activity, financial structures are seriously eroded. I have mentioned above several examples of companies which, in order to remain independent, have depleted their equity and taken on excessive debt. Several of the largest takeovers were brought about as a result of raids, financed by junk bonds, on the target companies which were then acquired by third parties. A large part of the oil industry has been badly damaged as a result. Chevron-Gulf, Occidental-Cities Service, Mobil-Superior occurred as a result of raids or the threat of raids. The deterioration in their combined balance

sheets has been dramatic. The premiums received by the acquired shareholders have been paid by the debt of the acquiring companies and, ultimately, by their shareholders. Far from being a healthy restructuring, the oil companies involved are cutting exploration sharply, a practice our country will pay for dearly when the next energy crisis occurs. In the meantime, as a result of their high levels of debt, they could be in serious difficulty, in the near term, if the price of oil continues to decline. If one were to write a scenario about how to get the U.S. into trouble as far as energy is concerned, it would be hard to improve on what is happening.

It is in the area of large takeovers that the junk-bond phenomenom is particularly hazardous. High-yield, unrated debt, in reasonable amounts, is a perfectly acceptable financing vehicle for many companies ineligible for investment-grade credit ratings. It is a different story, however, when this type of debt, in the billions of dollars, is used to substitute for equity in the takeovers of very large companies.

The risk in this type of operation is twofold. First, in the actual security of the paper. If the takeover is successful, the servicing of very high levels of debt, at rates of interest in excess of most targets return-on investment, requires significant asset dispositions which

may not always be possible or desirable. It is an approach that also completely fails to take into account the fact that a large corporation is an entity with responsibilities to employees, customers and communities, which cannot always be torn apart like an erector set. The alternative to a breakup requires significantly improved operating performance which is very often much easier said than done. Indeed, in looking at many of these raids, one is left to wonder if the intent is really to acquire control or simply manipulate a third-party takeover in order to make a profit with little or no risk.

The second element of risk in this type of paper is liquidity. Much of this paper is privately placed, among a small group of private investors initially, and subsequently to financial institutions such as savings banks, insurance companies and pension funds. In many instances, no large scale, liquid public market exists in these securities and purchases and sales are handled through private transactions. Many of the investing institutions are in financial sectors under considerable pressure at this time.

To protect themselves against this type of takeovers, companies have begun large scale restructurings of their own whereby they assume significant amounts of additional debt in order to shrink their equity and increase the price of their stocks. ARCO and Litton Industries are the most

recent example of this trend, the latter shrinking its capital base by more than one third. Whether in the long run, this is sound financial policy and good for the country is open to question. It is highly probable, however, that these restructurings are driven more by the fear of these types of takeovers than by straightforward economic forces.

A new and potentially dangerous variation of this type of transaction is the transaction presently proposed by Turner Broadcasting Co. in its attempted takeover of CBS. This approach uses an exchange offer to offer junk bonds directly to the CBS shareholders. The objective is to have a sufficiently active speculative market created for the bonds, either by listing on an Exchange or otherwise, to induce CBS shareholders to take a quick profit and deliver control of the company to the bidder. A breakup of the Company is inevitable since the bonds cannot possibly be serviced by the ongoing business.

This last approach can only be controlled if the SEC refuses to register bonds that do not meet certain minimum tests of viability and if the securities exchanges refuse to list them. This kind of junk bond takeover is a new device and should not be allowed to become another takeover abuse.

Junk bonds, of course, are not the only source of excessive leverage in recent takeover activity. Large scale leveraged buyouts and "going private" transactions have been financed by bank and institutional loans in the tens of billions of dollars as well as by junk bonds. The result is more and more substitution of debt for equity and less and less stable financial structures.

c) Added to this combination of unequal treatment of shareholders and unsound financial structures is the market speculation which has become an integral part of the process. Very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools, incidentally are financed by junk bonds. Very large pools of money are in the hands of raiders, similarly financed. This creates a symbiotic set of relationships which has as its basic purpose the destabilization of a large corporation, and its subsequent sale or breakup. It creates, at the very least, the appearance, if not the reality, of professional traders with inside information, in collaboration with raiders, deliberately driving companies to merge or liquidate. The process is driven by the ability of raiders to make tender offers "subject to financing", thereby avoiding costly commitment fees, and getting a free ride if they are bought out with "greenmail" or the target company is taken over by a white knight. St. Regis Paper, Gulf Oil, Cities Service were forced for merge as a result of this process.

In summary, what does all this add up to?

1) At a time when we are trying to encourage long-term investment, this activity encourages speculation and short-term trading;

2) At a time when we are trying to strengthen our important industries to make them more competitive, this activity weakens many of our companies by stripping away their equity and replacing it with high-cost debt;

3) At at time when our financial institutions (banks, savings banks, insurance companies) are under considerable pressure, this activity preempts more and more general credit and causes the weakest sectors to acquire large amounts of risky and possibly illiquid paper to show performance. Much of this paper has never been tested in a period of economic downturn.

4) At a time when we need to continue attracting capital from all over the world, our securities markets appear to be more and more under the control of professionals and insiders. The rights and privileges of shareholders appear to be continually eroded.

I believe that these issues are sufficiently seriousto warrant the relevant regulatory authorities and the Congress to consider more stringent regulation coupled with new legislation.

To curb excessive use of junk bonds:

a) Federally and state-insured and regulated financial institutions should be sharply limited in their ability to invest in obligations carrying below-investment grade credit

ratings and/or lacking a bona fide public market;

b) Tender offers "subject to financing" should be prohibited as a manipulation of the public markets. Anyone making a tender offer should be required to have firm financing commitments in hand for 100% of the required capital.

To curb the excesses of takeover activity both on the part of bidders and targets:

a) Any acquisition of more than 20% of a company's stock should require an offer for 100% at one price, unless it has the approval of the target's board.

b) The minimum tender-offer period should be extended to 60 days;

c) Shareholder approval should be required of the bidder's shareholders if the target represents more than 25% of the market value of the bidder.

Shareholder approval should be required of the target's shareholders if the target proposes to reacquire more than 5% of its shares, to issue or option securities having more than 10% of its voting rights, or to sell or option assets having a value of more than 10% of its market value.

To maintain the integrity of stock ownership, we should:

a) Eliminate any form of "poison pill".

b) Delist companies with various classes of voting securities.

c) Eliminate "shark repellents," staggered boards, "fair-price amendments" and similar devices.

These actions should be part of a total package of legislation and/or regulation. They are all interconnected. It would be unreasonable to remove defensive devices such as "poison pills" from a company's use unless abusive takeover tactics were limited in a similar vein.

It seems to me that such an approach would be essentially neutral as to bidders or targets, subjecting all major corporate decisions to shareholder approval. It removes the need for hasty, and often exceedingly self-detructive, defensive actions and avoids the need to deal with the "business judgement" rule by making major coporate structural changes subject to shareholder vote.

In the area of excessive use of credit, whether junk bonds or otherwise, I believe that regulation as opposed to legislation can handle most of the problems. The SEC and its tender offer rules, the margin rules and the capital requirements set by Federal and State regulators of banks, insurance companies and savings institutions, can deal with most excesses if the regulators decide to act or are directed to do so.

I have made my living, for more than thirty years, negotiating hundreds of mergers and acquisitions for a variety of corporate clients. Most of these were the result of negotiated agreements; some were bitterly contested, hostile takeovers. I hope to continue this activity for many more years. I believe it to be an integral part of the service an investment banker should provide his clients and that it is an important and constructive factor in maintaining a competitive market place. There is no question in my mind that thoughtfully negotiated mergers have a better chance of achieving their objectives than multi-billion dollar takeovers, or major restructurings, decided upon over a weekend, as a result of a raid. Nonetheless, there should be room for many types of transactions in our market system, but very clear lines should be drawn between what is acceptable economic and corporate behavior on the one hand, and what is runaway speculation on the other. That is not the case today.

There are always arguments against any changes. Regulation and legislation are, inevitably, imperfect and may, unwittingly, restrict perfectly valid activities. However, the integrity of our securities markets and the soundness of our financial institutions are vital national assets. They are being eroded today and regulatory and legislative actions are required to protect them.

* * *

Senator D'AMATO. Thank you very much, Felix.

Mr. Joseph, and, again, I say that your statement will be accepted into the record as if read in its entirety. But if you wish to read the entire statement, or summarize it——

STATEMENT OF FREDERICK H. JOSEPH, VICE CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, DREXEL BURNHAM LAMBERT, INC.

Mr. JOSEPH. Thank you. I'm Fred Joseph, vice chairman and chief executive officer of Drexel Burnham Lambert. I'd like to thank you for extending the invitation to be here today.

Drexel Burnham is the country's second largest private investment banking firm, with over $750 million in capital. We are often credited with developing the public market in high-yield debt securities, often, pejoratively, we think, referred to as junk bonds.

I intend to discuss the nature of high-yield debt, the liquidity of the market, its role in corporate takeovers, and the advisability of thrift institutions participating in this market.

TAKEOVERS—LEGITIMATE ASPECT OF MARKET

We regard takeovers as a legitimate aspect of free market capital allocation. Ultimately, shareholders, as owners, bear the risk associated with any company, and accordingly, ought to have the right to control its destiny.

Both sides in past takeovers have often used excessively aggressive tactics, but the natural forces of the marketplace should cure most of these abuses, and appear to be doing so.

We believe that arguments against hostile takeovers based on overleveraging and sale of asset arguments ignore the economic realities which underlies restructurings.

The Williams Act has successfully promoted a level playing field. Now it appears to us that the level playing field is tilting from side to side with unnecessary and dangerous volatility. The recent Delaware decision upholding a discriminatory self-tender is, in our judgment, a violation of the principle that all tendering shareholders should be treated fairly. And it's my opinion that this will significantly reduce takeover activity.

In specific cases, legislation may make sense to ensure that shareholders, aggressors, and target companies have a fair opportunity to act responsibly.

For example, the 10-day notification requirement under rule 13(d) creates opportunities for abuses and should be addressed. The penalties for making misleading or incomplete 13(d) disclosures should be increased. Exchange offers ought to be put on an equal footing with cash tender offers. The Hart-Scott-Rodino loopholes need to be closed. Greenmail should be eliminated, although it will probably disappear under the weight of its own ineffectiveness. And the defensive use of poison pills should be examined.

Despite the widespread attention which high-yield bonds have attracted in connection with takeovers, they have not been a major source of funding for mergers and acquisitions. Of the $122 billion used to finance mergers and acquisitions in 1984, less than 2 percent came from high-yield bonds.

The primary function of high-yield bonds is to provide midsize growth companies with access to the public market for capital. These securities are simply public corporate debt issues rated below investment grade; that is, below Baa by Moody's and BBB by Standard & Poor's. Some bonds have always offered above-average yields. Historically, these were bonds which had originally been investment grade, but whose credit had deteriorated. When the newly issued high-yield bond market opened up in 1977, that innovation made public debt available to companies rated below investment grade for the first time.

It is critical to understand that under 600 companies are rated investment grade by the major rating agencies. There are over 19,000 companies with assets in excess of $25 million which do not qualify. In assigning ratings, the agencies rely heavily on historic data and size, which are not necessarily valid indicators of future capability to service debt.

High-yield bonds as a financing instrument effectively replaced private placement term loans traditionally made by insurance companies. And in many cases, high-yield bonds allow companies to replace short-term floating rate bank debt with long-term fixed-rate capital.

Investors have learned that marketability of bonds typically provides better protection than restrictive covenants.

There are approximately 1,400 issues outstanding in the high-yield bond market, with an aggregate market value of between $75 and $100 billion. We believe that the daily dollar trading volume occasionally approaches that of the New York Stock Exchange and averages between 10 and 20 percent of big board volume.

The market has grown fairly steadily since 1977, reaching $14 billion of new issues in 1984. More than 350 companies have used the public market to issue $35 billion of new high-yield debt since 1977, thereby creating thousands of jobs.

For example, in the past 5 years, Drexel Burnham has underwritten three high-yield bond issues totaling $1.4 billion for MCI Corp., six issues totaling $130 million for Charter Medical and a number of issues for Kinder-Care Learning Centers.

EMPLOYMENT RISES DRAMATICALLY

Employment at these three companies has risen dramatically over the past decade; from 650 to over 10,000 at MCI, from 3,500 to 9,700 at Charter Medical, and from 900 to nearly 11,000 at Kinder-Care.

In general, far more jobs are created by smaller and midsized companies than by Fortune 500 companies, which have actually reduced employment in recent years.

Large institutional investors, which are essentially risk-averse, began to buy high-yield bonds only after they recognized that the premium they could have earned for accepting an increase in perceived risk has exceeded actual default losses by a multiple of over 5 to 1 since 1900. In fact, more money has been lost in the bond markets through the downgrading of investment grade debt than through defaults of below investment grade issues.

Confirmation of high-yield performance is available in a number of academic studies. An analysis by the Wharton School concludes that:

> In the context of a well-diversified portfolio, the risk of lower-quality bonds was no greater than the risk of high-quality bonds.

Despite recent increases in the volume of high-yield bonds, we believe that the credit quality of high-yield bond issuers has improved meaningfully over the past 5 years. The proportion of new issue, high-yield bonds rated BB has increased from approximately 21 percent of dollar volume in 1979 through 1981 to nearly 42 percent in 1984. The average issuer's net worth has increased from $64 to $323 million during the same period.

There have also been claims of high-yield bonds structured for use in takeovers are of low quality, thereby discrediting historic default ratios. On the contrary, because of the hostile environment and the speed with which such financing must be arranged, these issues have been of higher credit quality than other issues providing comparable returns.

While significant attention is focused on savings and loan association investments in high-yield bonds, such bonds currently account for approximately one-half of 1 percent of the thrift industry's total $1 trillion in assets.

S&L's that buy high-yield bonds have achieved a consistently higher return on their investments with little additional increase in overall risk. High-yield corporate bonds provide S&L's with a vehicle through which they are able to break into the commercial lending field and earn higher returns while maintaining liquidity.

As thrifts strengthen their financial condition with improved earnings, they can raise additional capital by becoming issuers of high-yield bonds. Nearly $800 million in capital has been invested in the thrift industry through the issuance of thrift high-yield bonds during the past 12 months. Drexel Burnham has raised nearly three-quarters of that amount.

It is a common misperception that high-yield bonds were somehow related to the recent failure of several savings and loan associations in Ohio and Maryland. As far as we know, none of the Ohio or Maryland thrifts that encountered difficulties owned any such bonds.

We do recognize that high-yield bonds are more complex investments than mortgages and would support some restrictions and investment guidelines for thrifts. We recommend that the appropriate regulators encourage thrifts to adopt guidelines which examine the creditworthiness of issuers, diversification, which is critical in the management of a high-yield bond portfolio.

Thrifts should also be encouraged to establish a loss reserve if they wish to invest in high-yield bonds. They perhaps should be subject to more rigid minimum net worth tests.

Furthermore, a minimum investment criteria could be used to compel smaller thrifts to make high-yield bond investments to diversified pooled accounts.

Finally, commitments should be treated as actual investments for the purposes of these guidelines. The current low interest rate environment provides the thrift industry with an excellent oppor-

tunity to generate profits, restructure portfolios, and increase net worth.

We recommend that the thrift regulators take advantage of this window to formulate new, more rigid approaches to strengthen the capital requirements of the industry. The stronger capitalized thrifts could then be allowed to diversify further so that they could generate profits through all phases of the economic cycle and continue to provide funds to the housing industry.

Thank you.

[The complete prepared statement follows:]

STATEMENT OF

FREDERICK H. JOSEPH

VICE CHAIRMAN AND CHIEF EXECUTIVE OFFICER

DREXEL BURNHAM LAMBERT INCORPORATED

Mr. Chairman and Members of the Subcommittee:

I am Fred Joseph, Vice Chairman and Chief Executive Officer of Drexel Burnham Lambert. I would like to thank you for extending the invitation to be with you today.

Drexel Burnham is the country's second largest private investment banking firm, with over $750 million in capital. We are often credited with developing the public market in high yield debt securities, commonly, and we think mistakenly, referred to as "junk bonds."

There has been significant misinformation regarding the nature of high yield debt, the liquidity of the market, its role in corporate takeovers and the advisability of thrift institutions participating in this market. I would like to take this opportunity to clarify the facts, and make some recommendations regarding these issues.

Corporate Takeovers

We regard takeovers as a legitimate aspect of free market capital allocation. Ultimately, shareholders, as owners, bear the risk associated with any company, and accordingly, ought to have the right to control its destiny. As a rule of thumb, control of a

company is worth, on average, one-third of the company's market equity value. With some $1.5 trillion of market equity value outstanding in the United States, control therefore represents over $500 billion of value. Should control of this $500 billion be in the hands of entrenched management or in the hands of shareholders, the real owners?

In past takeovers both sides have often used excessively aggressive tactics, but we think that the natural forces of the marketplace will cure most such abusive practices.

President Reagan's Council of Economic Advisers, in its 1985 report, concludes that "the success of the American economy depends on competition. Competition stimulates managers to respond to rapidly evolving technologies. Competition requires that firms adapt to changing market demands and calls upon them to adjust to fluctuating capital market conditions."

And most economists agree with Professor Michael Jensen's study published in the Harvard Business Review, which points out that, "scientific evidence indicates that activities in the market for corporate control almost uniformly increase efficiency and shareholders' wealth."

Two arguments against hostile takeovers are that the successful bidder must sell off assets to pay the acquisition debt and that the corporation that mounts a successful defense does so by leveraging itself. Certain commentators would have us believe in the "black hole" theory in which the assets that are spun off from a target company suddenly disappear, or fall into a "black hole." Nothing could be further from the truth. Asset divestiture is a necessary corporate strategy to insure competitiveness and adequate rates of return. Corporate restructuring is largely a reaction to the diversification and conglomerate trends of the 1960's. Dozens of companies, such as W.R. Grace, General Electric, ITT, R.J. Reynolds and Tenneco, are voluntarily trimming their operations with an eye toward improving shareholder values. Litton Industries has also commenced an exchange offer of debt for certain of its outstanding shares.

Other companies, particularly in the oil industry, also have recently adopted restructuring programs to benefit shareholders. Changes initiated by Atlantic Richfield will ultimately produce fewer shares outstanding, higher earnings per share, and a higher dividend. Exxon similarly is continuing its efforts to improve its return on shareholders' equity. The company has repur-

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chased some 96 million shares, or 11 percent of its previous common share capitalization. It should be noted that Exxon has more capital expenditures and exploration planned for 1985 than it did for 1984.

These restructuring programs are caused by economic forces independent of takeovers, although it is not unlikely that their timing and the measures adopted were influenced by recent takeover activity. While reasonable people may differ on the merits of hostile takeovers, we believe takeover activity leads to more finely tuned restructuring programs.

Managers may resist change, but change is critical to the evolution and growth of our economy. Time will tell whether or not the restructuring of the oil industry will yield results. We do know that no pressure was brought to bear on managers in the steel industry 15 years ago. They did not restructure their companies, and the nation is faced today with the results of their failure to act. Perhaps it is time to try another approach.

High yield bonds have been criticized as a culprit in the alleged over-leveraging of the U.S. economy. However, the evidence shows that corporate debt as a percentage of gross national product has been relatively stable in the U.S. over the past 10 years. Furthermore,

the extraordinarily low default rate of 0.08 percent for all U.S. straight corporate debt over the last 10 years indicates that U.S. companies as a group can afford to assume more debt without raising default levels to an unacceptable level. Finally, the use of high yield debt in a company's capital structure often substitutes for equity, which is the scarcest and most expensive form of capital.

Corporate takeover activity is a matter that deserves careful deliberation. The Williams Act has quite successfully promoted a level playing field between the acquiror and the target. This level playing field has operated in the shareholders' best interests. Now, however, the playing field is tilting from side to side with unnecessary and dangerous volatility. The recent Delaware Supreme Court decision in the Unocal case upholding a discriminatory self-tender is, in our judgment, a violation of the principle that all tendering shareholders should be treated fairly.

In specific cases, legislation may make sense to ensure that both the aggressor and target company act responsibly. For example, the 10-day notification requirement under Rule 13D creates opportunities for abuse and should be addressed. Penalties for making misleading

or incomplete 13D disclosures should be stiffened. Exchange offers ought to be put on an equal footing with cash tender offers. The Hart-Scott-Rodino loopholes need to be closed. Greenmail should be eliminated, although it will probably disappear under the weight of its own ineffectiveness. Further, the use of poison pills as a defensive tool ought to be examined.

Role of High Yield Bonds in Corporate Takeovers

Despite the widespread attention which high yield bonds have attracted in connection with takeovers, they have not been a major source of funding for mergers and acquisitions. Of the $122 billion used to finance mergers and acquisitions in 1984, less than 2 percent came from high yield bonds. Most of these activities were financed by cash, bank borrowings or internally generated cash flow. Commitments to finance attempted takeovers with high yield bonds have been greater in 1985, but have actually been funded only in two instances, both of which ended up being friendly -- the acquisition of American Natural Resources by Coastal Corp. and the acquisition of National Can by Triangle Industries. Understandably, management of some large companies, previously impregnable to challenge because of sheer size alone, views with alarm the ability of smaller

companies to mount takeover bids. However, the discipline imposed by this potential competition appears to be a positive development.

The Market for High Yield Bonds

High yield corporate bonds are simply public corporate debt issues rated below investment grade; that is, rated below Baa by Moody's and BBB by Standard & Poor's. Bonds with above-average yields have always been available in the investment markets. Originally, these bonds represented the debt of investment grade corporations whose credit ratings subsequently deteriorated. In 1977, however, companies with credit ratings below investment grade began issuing high yield bonds. This innovation made public debt available to companies rated below investment grade. These companies include many of the nation's most promising enterprises.

It is critical to understand that about 600 U.S. companies are rated investment grade by the major rating agencies -- though there are about 19,000 companies with assets in excess of $25 million which would not qualify for an investment grade rating. In assigning ratings, Moody's and Standard & Poor's rely heavily on historic data and size, which are not necessarily valid indicators of future capability to service debt.

The primary function of original issue high yield bonds is to provide mid-sized growth companies with access to the public market for capital. They are attractive to both issuers and investors -- they effectively replace the term loans traditionally made by insurance companies and allow companies to replace short-term floating rate bank debt with long-term fixed rate capital. Furthermore, investors have learned that the marketability of high yield bonds provides better protection than restrictive covenants.

It is important to understand the breadth and depth of the high yield bond market. There are 1400 issues outstanding with an aggregate market value of between $75 to $100 billion. This includes all high yield bonds, including investment grade bonds that were subsequently downgraded. We believe that the daily dollar trading volume of high yield bonds occasionally approaches that of the New York Stock Exchange, and volume averages 10 to 20 percent of the Big Board volume.

The market for original issue high yield bonds has grown steadily since 1977, reaching $14 billion of new issues in 1984. More than 350 companies have used the public market to issue $35 billion of new high yield debt since 1977. This has resulted in the creation of

thousands of jobs for Americans. For example, in the past five years, Drexel Burnham has underwritten three high yield bond issues totaling $1.4 billion for MCI Communications, six issues totaling $130 million for Charter Medical and several issues for Kinder-Care Learning Centers. Employment at these three companies has risen dramatically over the past decade; from 650 to over 10,000 at MCI, from 3,500 to 9,700 at Charter Medical and from 900 to nearly 11,000 at Kinder-Care. In general, far more jobs are created by smaller and mid-sized companies than by the relatively few larger ones. In fact, Fortune 500 companies have seen net losses of jobs in recent years.

Large institutional investors, which are essentially risk-averse, began to buy high yield bonds only after they recognized that the premium they could have earned for accepting an increase in perceived risk has exceeded actual default losses by a multiple of over 5 to 1 since 1900. It has been proven empirically that these premiums are well in excess of the actual increase in risk. With premium returns averaging four to eight times the actual increase in risk, high yield bonds have been an unusually successful investment vehicle. In fact, more money has been lost in the bond markets through the

downgrading of investment grade debt than through defaults of below investment grade issues.

Confirmation of high yield performance is available in a number of academic studies. An analysis of investment returns for the period of January 1980 to June 1984 by Marshall Blume and Donald Klein of the Wharton School of the University of Pennsylvania found that below investment grade bonds produced a total return of 13.5 percent a year, almost double the 7.2 percent return for triple-A corporate bonds. The study concluded that, "[i]n the context of a well-diversified portfolio, the risk of lower-quality bonds was no greater than the risk of high-quality bonds." We recommend that investors diversify portfolios of high yield bonds, as do the professionals who dominate this market.

Furthermore, defaults have been below expectations. A study by Professor Edward Altman of New York University found that from 1974 to 1984, although the default rate on high yield bonds was higher than for corporate bonds, the actual losses were only about 1 percent annually because the defaulted bonds retained about 41 percent of their par value. The study concluded that even after taking into account losses from defaults, the high yield sector outperformed Treasury bonds by an annu-

al average rate of about 5 percent to 6 percent from 1978 to 1983.

Critics question the relevence of historic data on performance, citing the recent increases in volume of high yield bonds. We believe that the credit quality for high yield bond issuers has improved significanlty over the past five years. As measured by Standard & Poor's and Moody's bond ratings, the proportion of new issue high yield bonds rated BB has increased from approximately 21 percent of dollar volume in 1979 through 1981 to nearly 42 percent in 1984. The average net worth of an issuer has increased from $64 million to $323 million over the same period.

Claims have also been made that high yield bonds proposed for use in takeovers are of low quality, thereby discrediting historic default ratios. On the contrary, because of the hostile environment and the speed with which such financing must be arranged, these issues have been of higher credit quality than other issues providing comparable returns. They have been carefully structured to provide significant protection to the institutional purchaser.

Investment in High Yield Bonds by S&L's

Considerable attention has been focused on the role that high yield bonds play in the portfolios of savings and loan associations. High yield bond investments currently account for approximately 0.5 percent of the thrift industry's total $1 trillion in assets.

Savings and loan associations that buy high yield bonds have achieved a consistently higher return on their investments with little additional increase in overall risk. High yield corporate bonds provide S&L's with a flexible vehicle through which they are able to break into the commercial lending field, diversify their portfolios, and earn high returns. Unlike traditional commercial loans, however, high yield bonds can be resold or traded in a liquid secondary market.

As thrifts strengthen their financial condition with improved earnings, they can raise additional capital by issuing high yield bonds. Nearly $800 million in capital has been injected into the thrift industry during the past twelve months through the issuance of high yield bonds by thrifts. Drexel Burnham has raised nearly three quarters of that amount.

It is a common misperception that high yield bonds were somehow related to the recent failure of sev-

eral S&L's in Ohio and Maryland. So far as we know, none of the Ohio or Maryland thrifts that encountered difficulties owned any such bonds. In fact, the failures in the thrift industry during the last few years were due primarily to real estate-related problems and fraud.

Despite the excellent investment performance of high yield bonds, we do recognize that they are more complex investments than mortgages. Accordingly, we would support some restrictions and investment guidelines for thrifts. We recommend that thrifts adopt guidelines for investing in high yield bonds which require management to review the creditworthiness of issuers. We also recommend that investment diversification, which is crucial to the performance of a high yield bond portfolio, be encouraged by extending to investments in high yield bonds the current limitation of 15 percent of capital on a thrift's loans to a single borrower.

A loss reserve equal to 1 percent of an insured S&L's high yield bond investments or projected losses from such investments, whichever is greater, should be required to provide a loss cushion. Thrifts that wish to invest in high yield bonds should be subject to a minimum net worth requirement of the greater of regulatory net worth or 3 percent of total liabilities. Furthermore,

the minimum investment by an insured S&L in any one issue of high yield bonds should be $1 million. This restriction would compel smaller thrifts to make high yield bond investments through mutual funds or pooled accounts, which are diversified. Finally, commitments to purchase high yield bonds should be treated as actual investments for the purpose of these guidelines. Drexel Burnham believes that these guidelines will enable thrifts to intelligently take advantage of the excellent investment performance of high yield bonds.

Until recently, the ability of the thrift regulators to deal successfully with the problems of the thrift industry has been thwarted by the effects of high interest rates. However, the current low interest rate environment provides the industry with an opportunity to generate profits, restructure portfolios, and increase net worth. We recommend that the thrift regulators take advantage of this opportunity to perform a fundamental reappraisal of thrift capital requirements and formulate new approaches that will strengthen the net worth of the industry. Stronger capitalization will enable thrifts to diversify their portfolios further, which should lead to an even stronger industry that can generate profits throughout all phases of the economic cycle. This will ensure that, over the long run, the thrift industry is placed on a sound financial basis, while continuing to serve its primary role of providing funds to the housing industry.

Attachment 1

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THE WALL STREET JOURNAL FRIDAY, MAY 31, 1985

High-Yield Bonds Aren't 'Junk'

By Frederick H. Joseph

Heated rhetoric generated by recent hostile takeover controversies is giving high-yield bonds a bad name: by now everyone has heard the pejorative "junk bonds." This loaded language does nothing to clarify the facts.

Indeed, high-yield bonds have somehow been linked with a number of unrelated issues, such as fraudulent activities at E.S.M. Government Securities Inc., the financial problems of thrift institutions, bad commercial lending by certain U.S. banks, foreign loans, the overleveraging of America, practices of corporate predators and greenmail. Problems do exist in the financial markets, demonstrated by the thrifts' recurring difficulties and the bankruptcies of government securities dealers. However, these difficulties are totally unrelated to high-yield bonds. As far as we know, for example, none of the Ohio or Maryland savings and loans that encountered difficulties owned any such bonds.

Some bonds in the investment markets have always offered above-average yields, but historically these were bonds that had declined in value after originally having been issued as investment grade. When we at Drexel Burnham Lambert pioneered newly issued high-yield bonds, the innovation provided access to public capital markets to companies rated below investment grade, typically including the economy's most promising enterprises.

It is critical to understand that only 675 U.S. companies have been rated investment grade by the major rating agencies, though there are 20,000 companies with assets in excess of $25 million. In making ratings, Moody's and Standard & Poor's rely heavily on historic data and size, which are not necessarily valid indicators of future capability to service debt.

High-yield bonds effectively replace the private term loans traditionally made by insurance companies. Investors are protected from changing circumstances by market liquidity instead of the less efficient mechanisms of restrictive covenants found in private placement agreements.

Downgrading Causes Loss

The newly issued high-yield bond market emerged in 1977 when approximately $900 million of bonds were issued by middle-size and growing companies. The market has grown fairly steadily, reaching $14 billion of new issues in 1984. More than 300 companies have used the public market to issue $35 billion of high-yield debt since 1977. Many of these, such as Hanson Inc., MCI Communications, Coastal Corp., Beverly Enterprises, People Express and Kinder-Care, have recorded impressive results and have enhanced the growth of the nation's economy. Far more jobs are being created by small and middle companies than by the relatively few larger ones. In fact, Fortune 500 companies have seen net losses of jobs in recent years.

Institutional investors who buy corporate bonds are essentially risk-averse. This has led to a somewhat traditional market that pays investors premiums for accepting incremental risk. It has been proved empirically that these premiums are well in excess of the actual increase in risk and, with premium returns averaging four to eight times the actual increase in risk, high-yield bonds have been an unusually successful investment vehicle. In fact, more money has been lost in the bond markets through the downgrading of investment grade debt than through defaults of below investment grade bonds.

Confirmation of high-yield performance is available in a number of academic studies. An analysis by the Wharton School of the University of Pennsylvania of investment return for the period of January 1980 to June 1984 found that below investment grade bonds produced a total return of 13.5% a year, almost double the 7.2% return for Triple-A corporate bonds. The Wharton study concludes that, "In the context of a well-diversified portfolio, the risk of lower-quality bonds was no greater than the risk of high-quality bonds."

Furthermore, defaults have been below expectations. A New York University study found that from 1974 to 1984, although the default rate on high-yield bonds was higher than for all corporate bonds, the actual losses were only about 1% because the defaulted bonds retained about 41% of their par value. The NYU study concluded that even including losses from defaults, the high-yield sector outperformed Treasurys by an annual average of about 3% to 4% from 1975 to 1983.

As with any quality of bonds, investors should diversify portfolios of high-yield bonds, as do the investment professionals who dominate this market.

Only 675 U.S. companies have been rated investment grade, though there are 20,000 firms with assets of over $25 million.

Despite the press attention high-yield bonds have attracted, they have not been a major source of funding for mergers and acquisitions. Of the $122 billion used to finance mergers and acquisitions in 1984, less than 2% came from high-yield bonds. Most of these activities were financed by cash, bank borrowings or internally generated cash flow. Commitments to fund attempted takeovers with high-yield bonds have been greater this year, but have actually been exercised only in the highly regarded hostile-turned-friendly acquisition of American Natural Resources by Coastal Corp. Understandably, some managements of large companies, previously impregnable to challenge because of sheer size alone, view with alarm the ability of smaller companies to mount takeover bids backed by public debt. However, the discipline imposed by this potential competition is certainly a positive development.

There also have been claims that high-yield bonds structured for use in recent takeovers are of low quality, thereby discrediting historic default ratios as a measure of future security. However, no knowledgeable credit analyst who has reviewed these securities would agree with that assertion. On the contrary, because of the hostile environment and the speed with which such financings must be arranged, these issues have been of higher credit quality than other issues providing comparable returns. They have been carefully structured to provide significant protection to the institutional purchasers.

While reasonable people may differ on the merits of hostile takeovers, there is certainly significant evidence that such free-market activities benefit the economy as a whole. In a study in the Harvard Business Review, Prof. Michael Jensen found that "scientific evidence indicates that activities in the market for corporate control almost uniformly increase efficiency and shareholders' wealth."

A similar conclusion was drawn by President Reagan's Council of Economic Advisers. In its 1985 report, the CEA concludes that competition plays a central role in the evolution of the economy. "[It] breaks down entrenched market positions, unsettles comfortable managerial lives and provides incentives for innovative forms of business organization and finance."

An argument against takeovers is that the successful bidder must sell off assets to pay the acquisition debt or that the corporation that mounts a successful defense does so by leveraging itself. This restructuring, particularly in the case of the oil industry, is caused by real economic forces independent of takeovers, although timing and the particular measures adopted have been influenced by takeover activity. Atlantic Richfield recently adopted a restructuring program that will ultimately produce a higher dividend, fewer shares outstanding and higher earnings per share. Exxon is continuing its efforts to improve the return on shareholder equity. The company has repurchased some 98 million shares, or 11% of its previous common-share capitalization. Meanwhile, Exxon has more capital and exploration expenditures for 1985 than in 1984.

Whether the restructuring of the oil industry bodes well for our economy, time will tell. We do know that no pressure was brought to bear on managements in the steel industry 15 years ago. They did not restructure their companies and the nation is faced today with the results of their failure to act. Perhaps it is time to try another approach.

Diversification is Critical

Another red herring focuses on the role federally insured thrifts play as a purported major source of capital to finance takeovers. This position stems from the mistaken belief that S&Ls have been major participants in takeover financings.

In fact, thrifts have been relatively small participants in the newly issued high-yield bond market. We estimate they held between $3 billion to $5 billion of these securities. The Depository Institutions Deregulation Act of 1982 wisely authorizes such investments by thrifts to allow them to improve their risk-adjusted returns toward levels necessary to ensure their long-term viability. Clearly, such investments should be made prudently, subject to professional credit analysis within the thrift or retained by them on a pooled basis. Diversification, which is critical to the success of such an investment program, should be required, if not voluntarily pursued. Based on all available historic and current data, these investments will continue to provide above-average risk-adjusted returns to thrifts, in addition to the liquidity absent in mortgage and commercial loans.

Corporate takeover activity is a matter that deserves careful deliberation. In specific cases legislation may make sense to ensure that both the aggressor and target company have a fair opportunity to act responsibly. (For example the 10-day notification requirement under rule 13D creates opportunities for abuse and should be addressed.) But loaded words and dramatic rhetoric only cloud the discussion and make it more difficult to deal with these complex market events.

High-yield bonds are not the cause of takeovers, nor are they the primary source of capital used to finance them. They are the financial instruments used to provide middle-growth companies with access to the public market for capital and, as such, they have made a substantial contribution to our economic vitality and ability to compete globally.

Mr. Joseph is vice chairman and chief executive officer of Drexel Burnham Lambert.

A-30 The Wall Street Journal, Wednesday, June 5, 1985

Attachment 2

REVIEW & OUTLOOK

Takeovers: The Market Test

Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary. . . . The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates. . . .

The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process or industrial mutation—if I may use that biological term—that instantly revolutionizes the economic structure from within, incessantly destroying the old, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in. . . .

[T]he problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.

Joseph A. Shumpeter
"Capitalism, Socialism and Democracy"

So the greatest economist of our century described the essence of capitalism. And after listening to the big debate on corporate takeovers this year, we found our way back to his great book and particularly the chapter "The Process of Creative Destruction." For the longer we've thought about the subject the less we've come to fear a "takeover mania." Instead we fear some heavy-handed congressional regulation, if indeed the Delaware Supreme Court has not already gone too far with its recent ruling handing managements new defensive powers. The danger in inhibiting takeovers is cutting off Shumpeter's creative destruction.

Readers of this page have been able to follow a remarkable airing of the sides of the takeover debate: raider Sir James Goldsmith (Feb. 11), poison-pill inventor Martin Lipton (April 5), investment banker Felix Rohatyn (April 18), Prof. William J. Carney of Emory University (April 29), Gregg Jarrell and Kenneth Lehn of the SEC (May 1), Sen. Pete Domenici on his bill to regulate takeovers (May 14), Frederick Joseph of Drexel Burnham Lambert in defense of "junk bonds" (May 31).

Creative Destruction—I

An Editorial Series

Critics of takeovers like Mr. Lipton, Mr. Rohatyn and Sen. Domenici have undoubtedly been able to identify some problems. But many of them are either not unique to takeovers (high leverage) or already being sorted out in the marketplace (greenmail). On balance we have been more impressed by the arguments of the defenders. In particular, they can show that much of what is being criticized is legitimate investment banking—creating new financial instruments and new corporate structures more suited to the contemporary marketplace.

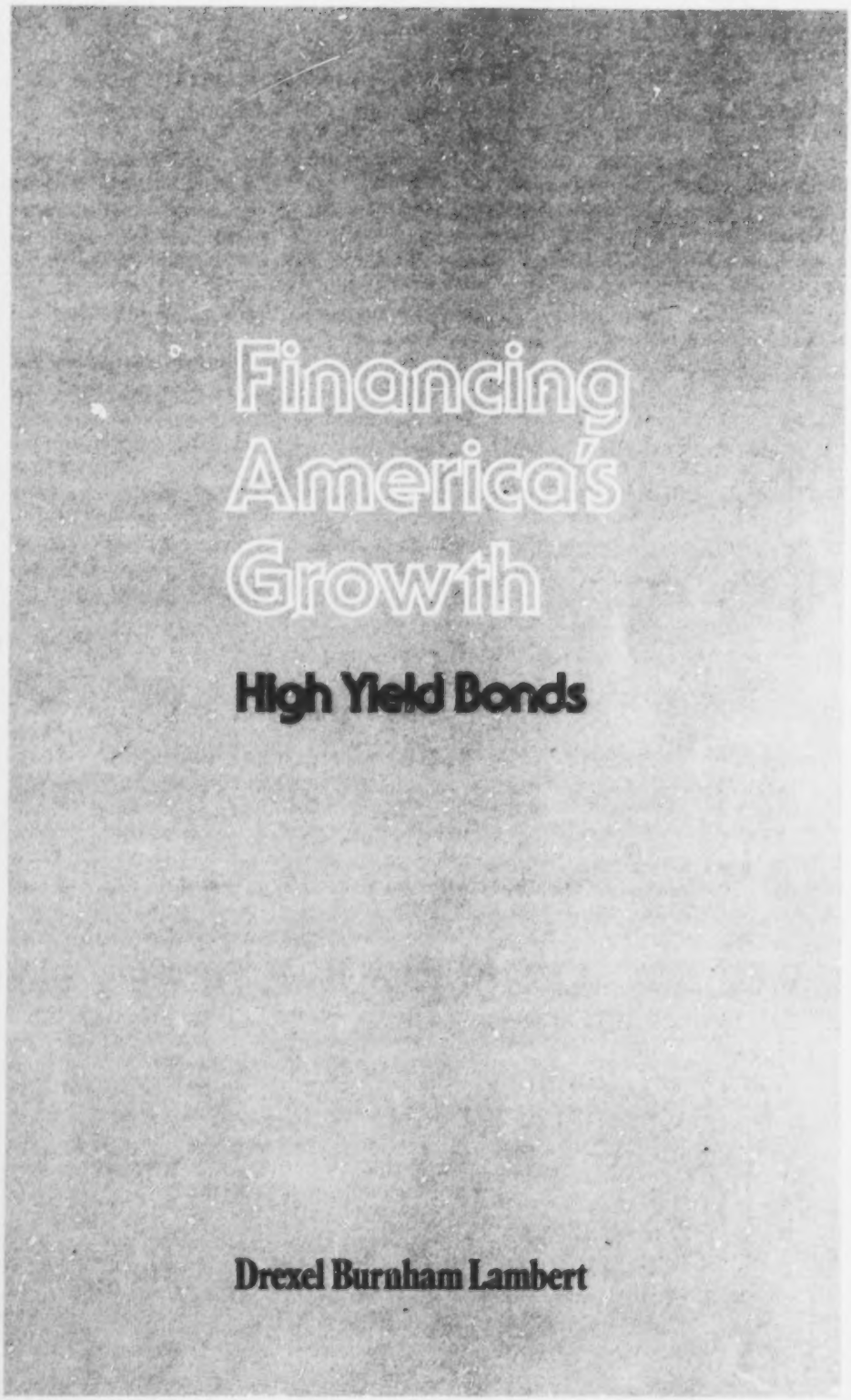
This is perhaps most easily seen by focusing on one issue, the "restructuring" of the oil industry. T. Boone Pickens gave his views on this issue in a Jan. 8 letter, and it was addressed quite independently of the takeover battles in a Feb. 21 article by John Sawhill of McKinsey & Co. The turbulence of energy prices in the 1970s has completely changed the environment for the oil industry, creating a glut of refinery capacity, leaving producing nations rather than international companies in control of oil reserves and greatly enhancing the importance of the spot market for crude oil. In these new conditions, the traditional vertically integrated oil company is no longer necessarily the best answer for either the investor or the consumer.

The problem is how to shed inefficient refinery capacity, take advantage of the spot market, and return cash flows from oil production to the capital markets so they can be redirected to other opportunities. It is not impossible to do this within the structure of present oil companies; refineries and retail outlets are being closed. Exxon, surely not under any takeover threat, has repurchased some of its shares, a way of returning money to the capital markets. But inertia attaches to any large bureaucratic structure, and even when raiders have not succeeded in ousting managements they have often been the catalysts for necessary restructuring.

This is certainly not to say that every takeover proposal is economically justified, let alone that the raiders are motivated by a public-spirited desire to improve economic efficiency. But legislators or judges who have to decide on takeover law ought to read "The Market for Corporate Control" in February's report by the Council of Economic Advisers, which concluded that takeovers add to economic efficiency and wealth, and should be not discouraged but encouraged.

In particular, it's important to remember that greed is disciplined by the marketplace, that by and large takeovers succeed only if a broadly diversified market approves. Wall Street still echoes with laughter at the cashless bid for CBS by Ted Turner, who is probably not motivated solely by economic considerations. Few such flimsy offers ever reach public prints. More often raiders are going to pick companies on which they think they can make money, junk bond dealers and buyers will back deals on which they think they can make money, the arbitragers will buy only if they think they can make money on a successful deal. And shareholders will sell only if the stock price goes up.

The market test of hostile takeovers may not provide absolute proof that every deal is an example of Creative Destruction at work. But the market, we submit, is a far better test than anything Congress is likely to devise.


Financing
America's
Growth
High Yield Bonds
Drexel Burnham Lambert

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Summary of Issues

- High yield bonds are all issues rated below "investment grade" — those which are rated Ba1 or lower by Moody's, BB + or lower by Standard & Poor's, or unrated. They have been dubbed pejoratively "junk bonds," a term originally used by the investment community to describe downgraded debt securities of companies which had suffered business downturns.
- There is a whole other universe of small and mid-size companies whose bonds are also rated below investment grade, but these should not be confused with bonds of troubled companies. Over 95% of all U.S. corporations with assets of more than $25 million, if they were to apply for a bond rating, would be rated *below* investment grade. These companies would be rated low due to their small size or lack of credit history, characteristics which do not tell the whole story of a company's financial prospects. Many of these companies are growing rapidly, are innovative and developing new technologies. They are responsible for the vast majority of all job formation in the United States. These growing companies can now raise much needed capital for all types of investments by underwritten public debt offerings. Investment bankers make a market in these bonds, providing investors with liquidity. This much expanded market encompasses a broad group of issuers of public debt.
- The higher rates of interest paid by high yield bonds have more than offset the risk of default, as compared to government or investment grade corporate bonds, so that investors in high yield debt have realized handsome yields. In fact, the Federal Home Loan Bank Board has stated that the risk of default on high yield bonds is no greater than that of ordinary commercial loans made by commercial banks and other federally insured institutions. In the period 1977 through 1984, Drexel Burnham estimates that the average loss of principal plus missed coupon payments from bankruptcies and other defaults has averaged 52 basis points per year for a portfolio of high yield bonds. However, this same portfolio has been earning 350 to 500 basis points above Treasuries and approximately the same amount (usually within 50 basis points) above AAA-rated corporate bonds. The result — investors have reaped, after taking defaults into account, a benefit of approximately 325 basis points from high yield securities as compared to Treasury issues and a similar (but slightly smaller) benefit as compared to AAA-rated corporate bonds of comparable maturity. Moreover, the rate of return for high yield bonds from 1980 through February, 1985 has been approximately 32 percentage points better than Treasuries and approximately 10 percentage points better than AAA-rated corporate bonds. The rate of return reflects both interest and growth in principal realized upon sale of the bond.
- Insurance companies, mutual funds, individuals, pension funds, savings institutions and other sophisticated investors purchase high yield bonds. These investors have recognized that the returns on these bonds more than compensate for the risk of default. Although exact figures are unavailable, Drexel estimates that thrift institutions hold under 10% of the current $59 billion public market of straight industrial and finance, and utility high yield debt issues. It is important to recognize that recent failures of thrifts in Ohio, and government securities dealers in Florida and New Jersey, are unrelated to investments in high yield securities.

■ High yield debt has also made an important contribution to acquisition activity by making capital available to finance acquisitions of larger companies. Previously, sheer size had prohibited economically advantageous acquisitions and protected large company managements, even if they were doing a poor job for shareholders. The practical effect for a long time was that size alone made the largest corporations (and their managements) immune from challenge. Now, smaller growth companies, which are often a great source of new ideas and more vigorous management, are able to raise the capital necessary to expand through acquisitions and internal growth.

■ It is sometimes asserted that leveraged acquisitions lead to sale of the acquired company's assets in order to retire the debt incurred in making the acquisitions. While this can occur, it is not unhealthy for the economy. The sale of assets unrelated to the target's main line of business may well allow the company to operate more effectively and competitively. The assets which are sold do not disappear — they often are transferred to stronger or more aggressive managements which more efficiently employ such assets to the benefit of the economy. These restructuring divestitures frequently occur voluntarily and as the result of normal market forces. The fact that such transactions also occur as a partial result of a successful tender offer should present no occasion for government intervention in the market.

Introduction

High yield securities have recently received widespread publicity for their importance as a method of raising capital for growing companies and for financing acquisitions. Unfortunately, the recent attention focused on the use of high yield debt for the financing of unsolicited tender offers has generated a number of misconceptions regarding high yield securities and diverted attention from the importance of these securities to the business community.

High yield securities are most commonly defined to include all issues rated below "investment grade"—those which are rated Ba1 or lower by Moody's, BB+ or lower by Standard & Poor's, or unrated. High yield bonds have been dubbed pejoratively "junk bonds," a term originally used by the investment community to describe debt securities of troubled companies. These troubled companies had entered the debt marketplace as mature, established enterprises with investment grade ratings, and for any number of reasons, such as technological changes or poor management, suffered business downturns. Their bonds were referred to as "junk" to reflect the issuers' fallen fortunes.

The bonds of these "fallen angels" are typically downgraded and then trade at a discount, resulting in a higher yield to investors. Frequently, however, downgraded companies are able to overcome their difficulties and their ratings are upgraded commensurately. When this happens, investors who purchased at a discount will realize an economic gain. Drexel Burnham Lambert has had extensive experience in analyzing the individual merit of these "junk" bonds and identifying those that have the potential to be restored to investment grade. Drexel Burnham found that these same techniques of analysis could be applied to small companies which do not yet qualify for investment grade ratings. These companies receive low ratings from Moody's or Standard & Poor's because they are emerging growth companies with little or no credit history. The rating agencies have always emphasized size above all, and also historical record, industry position and ratio analysis. Drexel Burnham recognized, however, that qualitative considerations such as the strength of a company's product lines, management's ability, its plans for the future and its attitude towards public security holders may be more important in assessing the financial prospects of a company.

Drexel Burnham has been successful in identifying these emerging growth companies ("rising stars") of corporate America. By underwriting the public debt offerings of these companies and trading their bonds, Drexel Burnham has enabled them to raise much needed financing and has greatly expanded the high yield debt market. Because the bonds of these emerging growth companies receive below investment grade ratings, they have unfortunately been tarred with the same brush as the "fallen angels" and hence are inappropriately called junk bonds. Drexel Burnham refers to these issues as high yield bonds to reflect the above-market rates of interest that they pay to attract investors.

It is important to recognize that over 95% of all U.S. corporations with assets of more than $25 million, if they were to apply for a rating, would be below investment grade. These companies include many of the ones that are growing most rapidly, are innovative and as a group are responsible for the majority of all job formation in the United States. It is from this segment that many of tomorrow's industrial powerhouses will emerge. Certainly the debt of these companies cannot be considered "junk."

The Market for High Yield Securities

Beginning around 1977, companies rated below investment grade shifted away from financing that was available through banks and insurance companies to obtain:

(1) permanent capital without the restrictive covenants these institutions imposed;
(2) greater visibility in public markets;
(3) increased institutional support from a broader base of creditors; and
(4) an alternative to depressed equity markets.

The high yield market has been instrumental in helping growing companies achieve these goals.

The high yield securities market is now very extensive. In past years this market tended to include only straight (i.e., not convertible into equity) industrial and finance issues rated below investment grade. Today, it also encompasses bonds of utilities and municipalities, preferred stock, high premium convertible bonds and private placements with registration rights. Drexel Burnham estimates the high yield market, when all of these are included, at about $100 billion. The largest public components are straight debt issues of industrial and financial corporations, which at the end of 1984* totalled about $48 billion (face value), and straight utility debt issues, which totalled approximately $11 billion. Since all public, straight corporate debt outstanding amounts to roughly $425 billion, the high yield segment represents over 14% of the total.

The high yield market's most visible part is securities created through new issues and, to a lesser extent, exchange offers and corporate reorganizations. Less visible are investment grade issues that often become part of the high yield market through downgrading (the "fallen angels"). In the past five years, for example, three major issuers—Ford Motor, Chrysler and Montgomery Ward—"dropped into" the high yield market before recovering to move back out. In the process, they added over $7 billion to the supply of high yield paper. These bonds had yield spreads as wide as 1,000 basis points as compared to Treasury bills. Today, with these companies enjoying the confidence of the investing public, some of these bonds trade at spreads as narrow as 50 basis points over Treasuries.

Companies "going private" have created a separate high yield subcategory. Taking that route in recent years have been such well-known companies as After Six, American Financial, CCI, Cole National, Condec, MacAndrews & Forbes, Metromedia, Midland Glass, Puritan Fashions, Rapid-American, Reliance Group, SFN Companies, and Twentieth Century-Fox Film. Generally, these buyouts have initially increased leverage and precipitated some rating downgrades. Many times, however, leverage is subsequently reduced through sales of assets not required to run the business. More importantly, the new owners typically have an equity participation and therefore have a greater incentive to perform. Thus far, none of the companies which have gone private has missed an interest or principal payment on its public debt.

Drexel Burnham estimates that since 1977 the size of the high yield public market has

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* Over $14 billion of new public offerings of high yield debt were made in 1984.

tripled. All in all, over the eight years through 1984, more than 350 companies have used the public market to issue $36.1 billion of high yield debt.

The expansion of the high yield market has been accompanied by a vast increase in the numbers and diversity of investors attracted to this market, including pension funds, insurance companies, mutual funds, individuals, banks and savings institutions, all of which have recognized the potential of the "rising stars" and how deceptive their lower ratings may be. Investor interest developed in three basic phases. During the late 1960s and early 1970s, major purchasers included individuals, high yield mutual funds and a limited number of insurance companies. In the late 1970s, pension funds, more life and casualty insurers, high grade equity mutual funds and more individuals became involved. Since 1980, the high yield market has broadened to include all types of domestic and foreign financial institutions, including savings institutions and commercial banks. Pension funds and insurance companies have increased their involvement. Drexel Burnham estimates that as many as 100 of the "Fortune 500" pension funds are currently investing in high yield bonds either directly or indirectly (through money managers). Some thrift institutions have prudently purchased high yield bonds to diversify their portfolios and take advantage of the high returns available. Although exact figures are unavailable, Drexel Burnham estimates that the holdings of thrift institutions of high yield bonds currently outstanding are under 10% of the current $59 billion public market of straight industrial and finance, and utility debt issues.

High Yield Bond Performance

High yield bonds have offered investors significant incremental yield without concomitantly increased risk.

A. **Return**

The DBL 100 Bond Index* has measured yield spreads versus relatively comparable-maturity U.S. Treasury issues since 1980. Average spreads have been:

1980:	359 Basis Points
1981:	394 Basis Points
1982:	499 Basis Points
1983:	346 Basis Points
1984:	319 Basis Points
1985(at 2/28):	362 Basis Points

Yield spreads of high yield bonds versus corporate bonds rated AAA are comparable to those in the above table since the yield of AAA bonds tends to correlate with that of Treasuries, typically with a spread of 50 basis points.

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* The DBL 100 Bond Index consists of the 100 largest high yield bond issues, measured by principal amount, maturing in 10 years or longer.

The DBL 100 Bond Index and the DBL Composite (since 1/1/85) have also measured the overall return of bonds in the high yield market included in these indices. The rate of return reflects the total value of the bond including principal and interest that a purchaser will have received when the bond is sold compared to the purchaser's initial dollar investment. From 1980 to 2/28/85, the total compound return for high yield bonds was 86.93% versus a 54.02% return for the comparable U.S. Treasury issue. The rate of return for the high yield market also compares very favorably to that available for investment-grade bonds with a rating of AAA. Rates of return are shown below:

	DBL 100	Tr. 8⅜%'00	Shearson-Lehman Long-Term Bond Index (AAA)
1980:	+ 0.93%	− 4.11%	− 2.60%
1981:	+ 2.73%	− 1.98%	− 0.15%
1982:	+32.48%	+44.18%	+44.52%
1983:	+19.73%	+ 0.45%	+ 8.32%
1984:	+ 8.50%	+13.67%	+17.61%
1985 (to 2/28):	+ 4.76%	−0.46%	− 0.29%
1980–1985:	+86.93%	+54.02%	+76.41%*

The performance of the high yield Drexel 100 compared to Treasuries was superior not only when principal values of bonds generally were rising, but also when they were falling. During 13 of the 20 quarterly periods in 1980-1984, the Treasury 8⅜% due 2000 declined in principal value. The total return of the DBL 100 exceeded the return on the Treasury issue in 12 of these 13 periods. It is important to note that the DBL 100 Bond Index has been less volatile than Treasury bonds and AAA– rated corporate bonds, as shown by the relative movement of rates of return presented in the table on page 9.

Another analysis of investment return over a similar period, January 1980 to June 1984, was done by Marshall E. Blume and Donald B. Keim of the Wharton School, University of Pennsylvania. Their December, 1984 research paper, "Risk and Return Characteristics of Lower Grade Bonds," calculated the compound rate of return for lower-quality bonds at 1.06% per month, substantially higher than the 0.58% for AAA corporate bonds. Messrs. Blume and Keim also found that "over these 4½ years, the realized returns on a portfolio of lower-quality bonds exceeded those of higher-quality bonds and those of common stocks." Blume and Keim confirmed the less volatile performance of the DBL 100 by noting that "lower quality bonds experience less volatility or risk than the higher grade corporates or equities."

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* This figure is adjusted to subtract an estimated 2.2% return from monthly compounding which is not present in Drexel Burnham's figures.

Further confirmation of high yield performance comes from Drexel Burnham's study of all high yield new issues underwritten since 1977. Drexel Burnham compared the total return of these 391 issues with the returns which would have been achieved from simultaneous, alternate purchase of the most comparable-maturity U.S. Treasury issues. The results were then "time weighted" (i.e., an issue outstanding for four years was given twice the weight of an issue outstanding for two years, etc.).

The high yield new issues produced a 3.63% compounded annual rate of return in excess of that achieved from the U.S. Treasury issues. Eighty-seven percent of the 391 issues outperformed the Treasuries. If the study had been weighted by issue size as well as time, the advantage over Treasuries would have been about 3.85% per year. The results of buying one of each of the 391 issues, versus an equal dollar amount of U.S. Treasuries are set forth below. As can be seen, the incremental return from the high yield bonds has been substantial.

	High Yield	Treasuries
Amount Invested:	$35.8 mill.	$35.8 mill.
Grew to:	$55.4 mill.	$48.2 mill.
Incremental Return:	$19.6 mill.	$12.4 mill.
Incremental vs. Amount Invested:	+54.7%	+34.6%

Moreover, as the following table demonstrates, investors who bought issues initially rated below investment grade received a significantly greater reward:

Initial Rating	Annual Return vs. Treasuries (in percentage points)
BBB by Standard & Poor's	+3.02
BB by Standard & Poor's	+4.43
B by Standard & Poor's	+3.87
CCC by Standard & Poor's or Moody's	+5.49

Note: All ratings in the above table below BBB (which is investment grade) are considered to be in the high yield category.

B. **Risk**

The premium interest rates offered by high yield bonds have more than offset the risk of default, as compared to government or investment grade corporate bonds, so that investors in high yield debt have realized handsome net returns. Although high yield bonds do have a higher default rate than investment-grade bonds,* a default

* It is important to recognize that investment-grade securities fall into the high yield category before the issuer defaults. In order to compare default rates, bonds which start out with below investment-grade ratings must be considered separately from investment-grade bonds which default after they pass into the high yield category. Drexel Burnham's calculations indicate that during the period from 1977 through 1984, less than 0.8% of all high yield bonds were in default. This figure properly excludes bonds that were initially investment grade but were downgraded prior to default.

does not mean that a bond becomes worthless. Such bonds often continue to trade, albeit at a large discount. Drexel Burnham has studied the period from the beginning of 1977 through 1984, examining all straight debt issues (including all high yield bond issues) of $10 million or larger. Drexel Burnham's study indicated that the average loss of principal plus missed coupon payments from bankruptcies and other defaults has averaged 52 basis points per year for a portfolio of high yield bonds (the DBL 100 Bond Index). However, this same portfolio has been earning 350 to 500 basis points above Treasuries and approximately the same amount (usually within 50 basis points) above AAA-rated corporate bonds *(see supra* p. 7). Thus, if losses due to defaults are subtracted from the average yield spreads of the DBL 100 Bond Index, investors have reaped, on the average, a benefit of 325 basis points from high yield securities as compared to treasury issues of comparable maturity and a similar (but slightly smaller) benefit as compared to high-grade bonds.

Investors typically reduce the risk of default by diversification, i.e., investing in bonds of many different companies, the large bulk of which will not default on their bonds. Moreover, a portion of the risk associated with high yield bonds had been the undeveloped state of the market itself. Investors wishing to sell could not readily find buyers because brokerage companies did not make markets in high yield bonds. As high yield bond issuance has grown, however, their liquidity has increased.

It should be noted that the risk of default is only one of the two major risks borne by investors in all types of bonds; the second, price risk, is the risk that bonds will be traded at a discount if interest rates rise. The values of all high-grade or government bonds in a portfolio will decline when interest rates rise. The values of high yield bonds, on the other hand, are somewhat less sensitive to changes in the interest rate because they respond to changes in the financial outlooks of the individual underlying companies. By combining high yield bonds with other bonds, investors may be able to offset, at least partially, principal losses incurred because of rising interest rates. Thus, investing a portion of a portfolio in high yield bonds may result in a more stable rate of return than if the entire portfolio were invested in government or investment-grade bonds. Indeed, Blume and Keim found in their study that the lower price risk of high yield bonds offset their higher rate of default so that overall, investing in high yield bonds in a well-diversified portfolio is no more risky than investing in higher rated bonds for the same portfolio.

In addition, it should be noted that high yield bonds are often upgraded as the rating companies perceive a reduction in the risk of default. The following is a list of high yield securities whose ratings were upgraded to investment grade by either Moody's or Standard & Poor's in recent years. Acquisitions were responsible for some of these upgrades.

American Airlines
Aristar
Armstrong Rubber
Bache
Bangor Punta
Chrysler
Chrysler Financial
Columbia Pictures
Humana
Integrated Resources
Jim Walter
Lifemark (AMI)
Loews
Loral

Martin Marietta
Martin Marietta Aluminum
MCI Communications
Montgomery Ward
Montgomery Ward Credit
Moran Energy (Kaneb Services)
National Medical Enterprises
Outboard Marine
Paine Webber
PennCorp Financial
Pneumo
Reichhold Chemicals
Sherwin-Williams
Zayre

High Yield Debt in Acquisitions

High yield debt financing has made an important and highly positive contribution to the acquisition and leveraged buy-out field by making size less of an impediment to acquisition activity. Previously, sheer size had prohibited economically valuable acquisitions and protected large company managements, even if they were doing a poor job for shareholders. Because of the large amount of capital required to acquire a controlling interest in such corporations, mounting a competitive challenge was impossible for all but another large company (which frequently would be prevented from undertaking such a challenge by antitrust considerations). The practical effect for a long time was that size alone made the largest corporations (and their managements) immune from challenge.

Raising the capital necessary to acquire large corporations through bank borrowings or other traditional financing methods is extremely difficult. Banks are less flexible in tailoring particular financing features to meet the requirements of particular large transactions. Further, certain lending institutions may be simply unwilling to advance the large amounts of money necessary for reasons unrelated to the risks of the loans. They may wish to minimize their involvement in highly publicized unsolicited acquisitions because their large corporate clients may express disapproval by refusing to do business with them. Also, they may fear becoming embroiled in the pervasive litigation that accompanies large deals.*

High yield bonds have made alternate sources of capital accessible to bidders for acquisitions and leveraged buy-outs. They are also more easily adapted to include the financing features required by a given bidder. Because acquirers have turned to high yield bonds rather than bank financing to finance acquisitions, bank involvement in acquisitions has been reduced and the attendant risks have been spread over a larger population of investors.

Opponents of acquisitions financed by high yield bonds assert that such transactions require a sale of corporate assets in order to repay the debt incurred in the acquisition. To the contrary, the decision to sell or retain assets after an acquisition often is not based on the nature of the debt or solely on the desire to retire debt. Management may decide for many sound business reasons that certain assets are not useful to the company and should be sold.

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* For example, Security Pacific Corp., a major bank, was recently sued by a corporate client, Unocal Corp., for allegedly making loans to a bidder with the knowledge that the funds would be used for a plan of acquisition. Unocal Corp. contended that making these loans violated the bank's fiduciary duty to its depositors. Security Pacific has denied the charges and intends to contest the matter.

An acquirer often may have determined prior to the acquisition that the target would operate more effectively and competitively by concentrating on its main line of business and selling unrelated assets. Competition in many industries (**e.g.** the natural gas-pipeline industry) has resulted in the liquidation of assets which are not essential to the core of the business. These assets do not disappear — post-acquisition divestitures usually result in such assets being transferred to stronger or more aggressive managements which more efficiently employ the divested assets and create new jobs.

Moreover, high yield bonds can help management retain useful assets. To the extent that borrowing large sums puts pressure on acquirers to reduce debt, bank financing is more likely to cause divestitures than are high yield bonds. Bank financing generally requires faster repayments, typically over seven years as compared to ten to twenty years for high yield debt. In addition, lenders frequently set the debt to equity ratios in bank loans at a level impossible for acquirers to meet without lowering the debt outstanding through the sale of assets. In the case of Metromedia Broadcasting Corporation's leveraged buy-out, conditions on the bidder's bank financing required the sale of a major television station and required high interest payments during the years immediately following the acquisition. The greater structuring flexibility of high yield debt, which the company used to retire its bank financing, enabled Metromedia to keep the television station and to significantly reduce interest payments over the short term.

Drexel Burnham would note that the percentage of high yield debt used in the merger or leveraged buy-out context is comparatively small. Of the approximately $14 billion of new high yield debt publicly issued in 1984, Drexel Burnham estimates that approximately 12% was issued in acquisition or leveraged buy-out transactions.

Conclusion

Ninety-five percent of all U.S. corporations with assets of more than $25 million, if they were to apply for a rating, would be below investment grade. Critics of the high yield market would have the financial community call all of these companies "junk." High yield bonds have provided a large number of companies rated below investment grade access to the capital markets. Moreover, investors in high yield bonds have received handsome and less volatile returns from these bonds, while the default rate has been reasonably low. High yield debt has also made an important contribution to acquisition activity by making capital available to finance acquisitions of the largest companies. Previously, sheer size had prohibited economically advantageous acquisitions because of the amount of capital required to finance such transactions. In addition, smaller growth companies, which are often a great source of new ideas, more vigorous management and new job formation, can now raise the capital necessary to expand through internal growth and acquisitions.

4/85

PROBLEMS OF JUNK AND HIGH-YIELD BONDS

Senator D'AMATO. Thank you very much, Mr. Joseph.

I think in your testimony, Mr. Joseph, you touched on some of your suggestions with respect to what regulations should or should not be imposed upon thrifts, and certainly touched on something that I know the Congress is very much concerned about—utilization of junk bonds or high-yield bonds by thrifts, particularly those that may have some severe problems.

In Mr. Rohatyn's testimony, on page 11, he says, and I ask you to respond:

> Federally and State-insured and regulated financial institutions should be sharply limited in their ability to invest in obligations carrying below-investment grade credit ratings and/or lacking a bona fide public market.

Having said that, would you care to comment in terms of what you might believe would be reasonable and what might go beyond and might be harmful to the very institutions that we're concerned about?

Mr. JOSEPH. I'd be pleased to comment.

I think, first of all, people have to decide whether high-yield bonds are, in fact, good investments which, risk-adjusted, provide better returns or are they junk?

We don't see, and no one has shown us, any evidence that high-yield bonds are bad investments, that on a risk-adjusted basis, you're not going to get a better return.

If we can accept the fact that on a risk-adjusted basis, high-yield bonds do provide an opportunity to increase earnings, it's our view that thrifts need the opportunity to improve their potential earning power. If you allow thrifts to invest 10 percent in high-yield bonds and they can increase their return by 3 percent per year, that's going to increase their return 30 basis points. That is a significant increase for thrifts. I would think that 60 basis points might be better. Ultimately, you don't want to lose track of the fact that thrifts; One, need to be viable; two, are needed if the industry needs additional capital; and three, their primary goal ought to be to finance housing.

I am concerned and have heard several Members of Congress suggest concern over the scenario in which you would have ill-capitalized or fully managed thrifts speculating in the high-yield bond market or, for that matter, in the real estate or the equity market—I've heard it called the heads, I win, tails, FSLIC loses scenario—we're very concerned about that.

And that's why we would encourage regulators to impose perhaps even more significant capital requirements in those thrifts to force them to get stronger, become stronger in terms of capital and then allow them the opportunity to diversify their investments so that they can improve their returns.

Senator D'AMATO. Are you saying, are you suggesting that, for example, unless there is a minimum capital, that they be precluded from activities in the bond market?

Mr. JOSEPH. I think that unless there's a minimum capital, they perhaps should be precluded from any diversification investment opportunities because they're apt to feel compelled to speculate.

On the other hand, if you can give them an opportunity to strengthen their capital and increase their potential for earnings diversification, allow the stronger ones increased diversification, you've got a better chance of improving the strength of the industry.

Senator D'AMATO. Mr. Rohatyn, Felix, having heard Mr. Joseph and his recommendation—how does that square with your thoughts about bringing adequate regulation to this area?

In other words, supposing we were to say that unless you had 6 percent capital or 7 percent capital, that you could not enter into this area? Supposing we then said that there should be a limit—say 10 percent of capital—and that as your asset value went up, obviously, you could participate more. It would seem to me this would dictate diversification so that you did not have an institution placing all of its investments in one or two high-yield bond issues.

Would that be moving in the direction that you seem to suggest in your first point?

Mr. ROHATYN. Yes, Senator, I think that that would move in that direction. I think you've got to be realistic about what we're dealing with here. The fact that an institution can show higher earnings temporarily from a high return doesn't mean that in the real world this is going to be around.

I mean, we have a lot of banks in this country showing very high levels of earnings because they're still reporting their interest income on Argentine and Brazilian and other loans that I'd hate to wait around to see paid back in my lifetime.

So that I think you have to look at the reality of an investment over some period of time which will test its validity. I think a lot of these instruments haven't been tested in a period of difficult times.

I would certainly limit the proportion of an institution's high capital that can be invested in any type of below-grade type of paper. I'd be inclined to treat some of this paper as if it were an equity security instead of a bond for certain purposes.

CAPITAL RATIOS HAVE TO BE INCREASED

Again, you've got to look at the reality of creating instruments which require servicing at rates of return that are higher than the rates of return of the companies that are underlying them and that's not always realistic in difficult times.

Senator D'AMATO. Let me ask, Mr. Joseph, going to point B on page 12 in terms of Mr. Rohatyn's conclusions, he said:

> Tender offer subject to financing should be prohibited as manipulation of the public markets. Anyone making a tender offer should be required to have firm financing commitments in hand for 100 percent of the required capital.

Why should there not be at least a minimum margin requirement, such as the 50 percent we today have on the marketplace. Why shouldn't there be some margin requirement?

And Mr. Rohatyn, after Mr. Joseph answers that, I'd like to get your feeling. What if you had 25 percent in cash—not just a commitment. What would that do and wouldn't that take away that era of speculation where someone comes in with the so-called junk bond, a letter of commitment, no money in hand, and looking basically to the assets of the target company to finance the acquisition.

I'd like both of you to comment on that.

Mr. JOSEPH. If I may comment first. First of all, on the question of commitment letters, clearly there's room for market manipulation activities in virtually all securities activities if people are willing to violate the laws. And the rules are very clear on market manipulation.

To my knowledge, I don't know of any—certainly I don't know of any tender offer done with a letter of commitment where it was not clearly obvious to the knowledgeable professionals that the company could raise the money. And in every case where the company has proceeded to the point where the money needed to be raised, it was raised.

I think if a firm, any firm, wrote a letter like that and then was unable to raise the money, they would be subject to accusations of market manipulation. It would be a tremendous risk.

Our firm's criterion is that the people working on the transaction have to assure me that they believe there's 100 percent probability of raising that money.

With respect to the question of margin rules and whether you need 25 or 50 percent equity in investments to acquire companies, it's our view that that was never the intention of the margin rules. The margin rules were designed to prevent excessive market speculation. They were not designed to set up appropriate capital structures for companies or for acquisitions.

I think, in fact, the 25-percent requirement would not materially change the level of activity in the marketplace, but I think you're using the wrong flyswatter. I just don't think that's what the margin rules are designed to do and don't think it's necessary.

We don't think we're seeing excessive speculation in the leverage buyout or leverage acquisition area.

Senator D'AMATO. Felix.

Mr. ROHATYN. I have a different view, Senator. I'd like to go back to Mr. Joseph's words—"fairly obvious to professionals."

I don't think that tender offers should be fairly obvious to professionals. I think that tender offers should either be financed or they shouldn't be financed, and it should be obvious to everybody whether they are, whether they're professionals or amateurs.

Senator D'AMATO. You say there should be 100 percent commitment.

Mr. ROHATYN. Absolutely; I see no—that doesn't mean you have to have the cash in the bank. That means you have to have a letter of commitment from a viable financial institution.

Second——

Senator D'AMATO. What about the margin requirement?

Mr. ROHATYN. I don't think margin requirements are relevant to this, Senator. I think if somebody wants to buy X,Y,Z Corp. for $1.5 billion, he ought to be able to show that he has credit available from a reputatable institution, firm and unconditional.

Senator D'AMATO. So you're saying if you have that firm commitment, then there would be no need for that margin requirement.

Mr. ROHATYN. That's right.

Senator D'AMATO. OK.

ROLE OF JUNK BONDS IN TAKEOVERS

Mr. ROHATYN. Second, I'd like to point out something else with respect to the use of junk bonds and takeovers. And Mr. Joseph is quite right in pointing out that of the actual takeovers, maybe only a limited amount was actually financed by junk bonds. But there were a whole slew of large companies that were taken over by other companies as a result of raids that were started by people financed by junk bonds. And those were in amounts that went way beyond anything we're talking about here.

Just as a small list, whether it's St. Regis Paper or Gulf Oil, or Cities Service, or Phillips, or Crown Zellerback. One way or the other, all of these companies came into play. Some were taken over, some restructured themselves—Unocal—as a result of junk bond-financed raiders who never took down the bonds, in the last analysis. So the amount of bonds actually issued was relatively limited, but their existence out there created the impetus which forced these companies ultimately either to be acquired by somebody else or to restructure themselves in a very, very leveraged way.

Senator D'AMATO. OK. Senator Proxmire—do you want to respond to that?

Mr. JOSEPH. I'd like to respond to one thing.

Senator D'AMATO. You're going to get a lot of chances, Fred, I'll tell you.

Mr. JOSEPH. OK.

Senator D'AMATO. My time is gone and you'll have an opportunity to respond later. I'd like to give the other Senators the opportunity to ask their questions.

Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Mr. Joseph, following successive raids on Phillips Petroleum by Pickens and Icahn, the company went from a 25:75 debt/equity ratio to a 75:25 debt/equity ratio.

Do you think that Phillips is a stronger company as a result of that debt?

Mr. JOSEPH. No. There's no question that increased leverage increases risk. The question is, I think: Was Phillips appropriately and aggressively maximizing its asset utilization and did it have an optimal capital structure prior to these two transactions?

And I think our answer would be, no, it did not. It was being too conservative.

Senator PROXMIRE. Well, they're a considerably weaker company, really, aren't they? Isn't that a serious problem, when you have an activity that drives a company from a very healthy equity situation to a position where they're deeply in debt?

We have that feeling here in Washington with the Federal Government, of course. We're struggling with a terrific national debt, enormous deficits. Most of us feel we have to impose big sacrifices on the public to overcome these deficits.

And here, you're moving along into an activity which, in the last year or so, seems to have greatly escalated corporate debt.

Mr. JOSEPH. I think, in aggregate numbers, corporate debt as a percent of the gross national product has not risen in recent years. I think it's a question of the probability of default as opposed—I

would disagree with the idea that Phillips is considerably weaker. I think the probability of Phillips having a financial problem and having to default is de minimus today and was de minimus before. Clearly, it's higher today than it was before.

But I don't think that company is at risk. I think they will have to sell some assets that they had, like the North Sea Oil, which most people did not think was a good investment.

CORPORATE DEBT

Senator PROXMIRE. Well, I challenge that statement you made, the corporate debt hasn't begun to increase very rapidly.

Last year, nearly $90 billion of corporate equity was exchanged for corporate debt.

Do you think that this is a healthy development to the economy?

Mr. JOSEPH. Yes, sir.

Senator PROXMIRE. You think it's a healthy development, that much of an increase?

Mr. JOSEPH. Yes, sir. I think that U.S. companies are, on average, underutilizing their potential capital assets. I think they're underleveraged.

Senator PROXMIRE. Well, how many more years do we have to go on increasing corporate debt before you will be concerned?

Mr. JOSEPH. I can't answer that question, sir. Debt issues are specific issues. It's each company's credit and each set of specific circumstances. There are companies with 20 percent debt to equity that are overleveraged. They're going to have trouble servicing their debt. There are companies with 90 percent debt that are in fine shape and are not going to have a problem.

Senator PROXMIRE. Well, I'll tell you why I'm concerned. I have here a record of nonfinancial corporate business and it's showing total liabilities going up at a fairly steady rate, until 1984, when they just go right through the roof.

Much of that increase, almost half of it, was because of the effect of corporate takeovers and the exchange of equity for debt.

So it seems to me that the statistics indicate that this is becoming a serious problem. If we move into a recession, it seems to me that our corporations are far more vulnerable than they've been in the past.

Isn't that right?

Mr. JOSEPH. I don't think so in aggregate. In specifics, in aggregate, I don't think I can tell.

There were—I don't remember the number now, but roughly 120 high-yield bond issuers who had issued high-yield bonds prior to the 1981–82 recession. And I would tell you that that recession was deep enough to suit me.

Most of them came through it well. The default statistics were well within the acceptable limits. The problems were industry-specific. The oil service industry had terrible problems. The communications industry had virtually no problems.

I really think it depends on which companies and which industries, what type of recession or depression we have. Clearly, I agree that increased debt, increased leverage increases financial risk, but

I think we've been operating at a suboptimal level in terms of the level of corporate debt.

Default rates have been 0.08 percent.

Senator PROXMIRE. Mr. Rohatyn, would you comment?

Mr. ROHATYN. Yes, I would be happy to, Senator. I think we're living in a time of financial insanity in this country at every level that I see, whether it's Government, whether it's private, whether it's corporate, whether it's financial institutions.

I think the weakest sector in our economy probably is the strength in the capitalization of our financial institutions. So in this climate, we are creating more debt to our basic producing enterprises at a time when they're under great pressure from international competition and haven't faced the fact that at some point, we're going to go into another recession.

I think stripping away $90 billion from the equity of corporations in this country in a year of great economic growth is insanity.

You're looking at a situation in the world where the price of oil could collapse next week or next month if OPEC falls apart, and you're creating companies that have cut back on their drilling activity very, very sharply because they can't stand the debt, and that are going to be in great difficulty if the price of oil were to come down.

And if, then, you extend that scenario a little more and take these companies into serious trouble, and some of them might go out of existence completely, and then look at the 1990's at a time when there might be scarcity of energy again, then you could have this country in great trouble.

INSANITY OF PILING UP CORPORATE DEBT

So, I think we're doing insane things on the credit side. I think we're doing insane things on the policy side.

I think it's the only Achilles heel that this country has today. It's much more the fragility of our financial institutions, the Third World debt problem, the internal debt problem that we're creating with our deficits. And at that time, when industry in the United States is under great pressure because of the dollar and because of a lot of things, to add on enormous amounts of debt to these corporate structures—maybe I'm getting old, Senator, but, boy, I think that's crazy.

Senator PROXMIRE. Well, I welcome that statement. We're aware of the colossal increase in the Federal Government's debt. At the same time, we're having a big increase in corporate debt and a debt that we owe increasingly abroad to foreign countries.

You're going to be followed by a panel, including Andrew Sigler, representing the Business Roundtable. He has a statement, and I'd like to read a short paragraph from that and ask your comment.

He says:

> Once before in this century, we lost sight of what business and corporations were all about. That was in the 1920's when, as now, the game was playing with corporations rather than running them. And it was dominated not by entrepreneurs and managers, but by people interested only in fast returns and speculative risks. We all know the consequences of that exercise in corporate game playing. What reason is there to think the end result of this round of the game will be any different?

Mr. ROHATYN. Senator Proxmire, I think that you'll find that Mr. Sigler's position and mine are rather close together. I mean, we may differ on some details. I don't disagree with him. I am very concerned.

I also want to hasten to add, I don't want to single out Mr. Joseph or anybody on this issue of overuse of credit. It isn't just junk bonds. I mean, credit is overused in this country in general. That's true of various kinds of quite conventional credit that are being used in leverage buyouts and in companies going private, where the equity of business is just disappearing.

I just don't think that we can live with this.

Senator PROXMIRE. In a free enterprise system, we know that recessions are one of the things that we have regularly. We expect that. We know that. They're going to happen.

The question is whether or not the situation we're getting into is going to aggravate that recession, because of the fragility, as you put it, of our corporations because of their heavy debt.

Mr. ROHATYN. Well, I think, Senator, it's certainly—when you have to service debt, that comes first. So that if you're in a financial situation where debt service becomes heavier, you're undoubtedly either going to shrink operations or not expand them because of the pressures created by debt service.

Now I serve on the board of directors of a large oil service company and we had a board meeting a couple of weeks ago and they showed us a slide of just the drilling activity of four of these big oil companies that had gone through mergers. I think in a 6-month period, and I may be wrong on the timing, but I think in a 6-month period, the rig count on these four companies, drilling rigs went down from 53 to 13.

Now, that is a dramatic reduction in drilling activity. Now you may say the price of oil is going down and we shouldn't be drilling any way. I don't think companies are supposed to be acting for 6-month timeframes. But they're acting because of debt service pressure.

You can obviously extend that throughout companies that go through these exercises, whether it's St. Regis Paper Co., whether it's—whatever company increases its debt has got to take the money right off the top.

Senator PROXMIRE. Now let me ask you something—Senator Domenici, I see, is joining us. The chairman of the Budget Committee is here.

He and I have been very interested in the so-called high-yield, maybe unfairly called, junk bonds issue. The argument has been made that these bonds are appropriate investments for an S&L, because the high-yield corporate bond is basically a commercial loan and shares many of the investment protection features of typical commercial loans.

But, in fact, isn't it true that the so-called junk bonds yield higher rates than commercial loans because they do not have the investment protection features of typical commercial loans?

Mr. ROHATYN. Well, I think the difference between a commercial loan and any kind of a bond is that a commercial loan, you have a direct relationship between the borrower and the lender. You can

make adjustments. You can have surveillance. You can readjust. You can do all kinds of things to protect your credit.

In a security, that relationship just no longer exists. There is no discipline mechanism or relationship for the types of protection that are built into the system of commercial lending.

But to me, these kinds of securities really have many more of the features of owning equity securities, with the disadvantage that an equity security doesn't bankrupt a company at a time of recession because it doesn't burden it with debt service it can't meet; whereas, a very high-yielding debt obligation in a time of recession might be so onerous as not to enable the company to ride through.

Senator PROXMIRE. My time's up, Mr. Chairman. Thank you.

Senator D'AMATO. Senator Hecht. But before Senator Hecht, I can see that Mr. Joseph is almost ready to jump out of the chair and I think it's good that this committee hear both sides. And that's why we've attempted to structure this in the manner in which we can get a divergence of opinions on these issues.

I'd ask Mr. Joseph to reply, to respond to Senator Proxmire's question as to his view with respect to whether we call them junk bonds or high-yield bonds vis-a-vis a commercial loan.

Mr. JOSEPH. Whew. Thank you. [Laughter.]

REASONS FOR THE RATE DIFFERENTIAL

I think there are several reasons for the rate differential. And the main one is that high-yield bonds are long-term, fixed-rate debt instruments. We think that that improves the safety, as opposed to short-term commercial loans.

Today, you have a steep yield curve. Government bonds are trading at around 10 percent while short-term bills are 300 or 400 basis points below that. And you have a steep yield curve in the corporate sector.

The risk, the financial risk to companies that hurt them the most in the past decade where those that had short- term commercial floating rate loans. When the prime rate unexpectedly cropped up to 21 percent, they were not prepared to service that interest cost.

So we think that you've had a significant reduction in financial risk by allowing companies to plan on their interest cost and to not be subject to the volatility of short-term rates. And that the main reason for the price differential, the interest rate differential today, is simply the slope of the yield curve, and this is, in fact, a healthier yield curve and a more conventional yield curve.

Senator D'AMATO. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Mr. Rohatyn, your name has been synonymous with corporate America for many, many years. You've done very well. The country has done very well the last 35 years.

Why all of a sudden do you come running to Congress? Why don't you take care of these problems in the New York Stock Exchange, where people are competent?

Why are you coming to us?

Mr. ROHATYN. I'm coming here because I was invited, Senator. [Laughter.]

Senator HECHT. But you have asked Congress to look at many things.

Mr. ROHATYN. Yes, I think you should. I think you should. I have done, as you say, very well. I have done extremely well and I'm very grateful. As I said, I've done hundreds of mergers, some of them friendly, some of them not so friendly.

And I'm not here to argue against takeovers because I believe that under many circumstances, they are very beneficial to the country and they've been very beneficial to me and my wife and my children.

I just think that there are things going on here that you should be aware of because I don't believe them to be necessarily in the national interest. Whether you want to do something about them or not, that's really up to you. We will live very well in this climate.

I'm not attacking junk bonds or Drexel Burnham. The more raiders try to take over companies, whether they're financed with junk bonds or not, the more business it gives for us because there are only half a dozen investment banking houses doing this business.

So that, in terms of my own selfish interest, all that is going on here is terrific. We have never been so profitable. We've never made so much money.

I think that in the last analysis, if this keeps up, it's going to be very bad for the country and therefore, I came down at Senator D'Amato's invitation to suggest that these are some areas that you might look at.

I think the stock exchanges are failing in their responsibilities. I think the SEC isn't regulating the way it should. But maybe that's OK.

All I'm doing here is saying, Senator, I think there are some problems here and you ought to look at them.

Senator HECHT. You've watched Congress over these 35 years, I'm sure. Do you feel that Congress is qualified to act on this?

Mr. ROHATYN. Well, Senator Proxmire and I made a terrific deal 10 years ago. We made a deal to not allow the city of New York to go bankrupt in exchange for a $1.5 billion guarantee, which was paid back, I think, about 30 days ago, Senator, if I'm not mistaken.

Senator PROXMIRE. In all fairness, if the gentleman would permit me to interject, I opposed that New York City bailout. [Laughter.]

If I had my way, the banks would have handled it in New York and I think they could have handled it very easily.

Mr. ROHATYN. But, Senator, not only did you get your money back; you made a profit. So it was a terrific deal for everybody. [Laughter.]

In any case——

Senator RIEGLE. There are some of us on the committee, by the way, that did agree.

Mr. ROHATYN. I know, Senator. I know, indeed.

Senator, if I didn't think the Congress could legislate things that were in the basic interest of this country, I'd emigrate. [Laughter.]

Senator HECHT. If you ask Congress to start legislating which is in the best interest of the American business, you'd better get your passport.

Mr. ROHATYN. I have it, thank you. [Laughter.]

Senator HECHT. Mr. Joseph, if we have all these regulations that have been proposed here, and I'm sure later on today, what would this do to restrict new companies coming up in America?

Mr. JOSEPH. It's hard to tell because I can't see where the track goes. But very clearly restricting—if high-yield bonds, which were last year the main source of permanent capital for emerging, growing, less-than-investment-grade companies, if high-yield bonds are not good for S&L's, then it makes me worry that the track then goes to the fact that they're probably not good for banks, they're probably not good for pension funds, they're probably not good for insurance companies.

That means that debt's not available.

So I think we have to be very, very careful not to throw the baby out with the bathwater as we think about some excesses in the takeover business and historic bad foreign loans and suddenly start talking about junk bonds and wrap them right in, as Mr. Rohatyn did in an article he wrote, with fraud in the Government securities market, and suddenly, you're reducing the availability of capital to midsize companies.

Senator HECHT. We're now entering the space age, so there's going to be lots and lots of new companies, hundreds and thousands of new companies.

CAPITAL NEEDS OF NEW COMPANIES

How can these new companies get started without available capital? In other words, by having certain types of restrictions on their capital, how much they can borrow, how much reserve—you know, once you start writing these rules, there's no stopping. There's always another loophole you have to plug.

How would these new companies get started?

Mr. JOSEPH. I think they'd have great difficulty. John Shad, in some testimony recently, pointed out that he thought that the capital markets were pretty good at judging risk versus income and that the laws of risk versus income should not be set by Congress or regulators or anyone else.

The venture capital equity market is a very delicate market. It's my view that the high-yield bond market is a delicate market. It's still relatively new. I think it has to be nurtured carefully. It's one of the reasons our firm is very concerned about people making appropriate investments in this market.

I think we're playing with very dangerous valves that have to do with the capital allocation process and the system overall appears to be working well at the moment.

Senator HECHT. We're having a dramatic recovery the last 4 years under the President. Approximately 6 million new people have been hired. Approximately 100,000 less people are on the Government payroll.

The majority of these people that have been hired are from small companies. Is that correct, Mr. Joseph?

Mr. JOSEPH. Yes, sir.

Senator HECHT. What is the perception of the Fortune 500 versus the 20,000 other companies—where is the greatest hiring?

Mr. JOSEPH. Very clearly, below the Fortune 500. I believe that the Fortune 500 has actually reduced its aggregate employment in recent years.

Senator HECHT. Then, Mr. Rohatyn, would this add to a recession by restricting the growth of small companies?

Mr. ROHATYN. Senator, I don't think there's anything anywhere in my testimony that infers that small companies shouldn't make use of high-yield bonds if that's appropriate. I think that the best thing you can do for small companies, which you're in the process of doing, is to lower capital gains taxes, which you have in the new tax reform bill, which I think will bring them down to 17½ percent.

The venture capital market is essentially an equity market and small companies should grow by being able to accumulate equity as rapidly as possible. Encouraging equity investment in these companies by lowering capital gains rates, encouraging equity investment by doing something about excluding dividends from certain types of taxation—that's the best thing you can do for these companies.

If these companies need to sell bonds at 15 or 16 percent, if that's appropriate, and I would think in many cases it would be probably a problem in terms of the development of their business, I have nothing against their selling those bonds. There's nothing in my testimony that indicates that.

I do think that there is a problem in using the lure of this kind of paper to tip over a company like Phillips Petroleum, or Unocal, or St. Regis Paper as part of a raid. I just don't think that that is appropriate. I don't think it's appropriate to substitute $4 or $5 billion of debt at twice the company's rate of return for equity as part of a takeover. That's all.

I have nothing against the use of anything to grow small high-tech companies. On the contrary. I think the best way to do it is through the equity mechanism and lower taxes.

Senator HECHT. I'm sure there are many reasons that this is not good and that's not good. But, again, my thrust is where does Congress start and where does Congress stop in regulating American business? Or do we regulate American business?

Mr. ROHATYN. You obviously regulate American business extensively. You regulate environmental questions. You regulate safety issues. You write the Tax Code, which is a regulation. You oversee the regulators.

So you have all kinds of ways to regulate, if you want to regulate. I'm not saying that you should. I'm just saying that here are some problems that I see that are creating forces that I think ultimately are going to be very negative to the economic growth of this country and to the stability of our financial institutions.

Senator HECHT. How—I'm sorry.

Mr. ROHATYN. You're going to have to come to some conclusions as to whether it warrants legislation, or whether you want to prod the regulators a bit, or whether you want to do nothing.

Senator HECHT. How do you feel about that, Mr. Joseph?

Mr. JOSEPH. I think that the heated debate around takeovers—and we understand that if you attack a company or someone goes to acquire a company in an unfriendly way, you're going to have a hassle. But I think that rhetoric has caught up a lot of peripheral

issues that are unrelated and clearly don't need regulation, like the high-yield bond business. I don't think you need legislation in terms of thrift investments in high-yield bonds. I think some regulation might make that a safer investment vehicle.

HIGH LEVEL OF ACTIVITY IS OVER

I, in fact, think that the high level of activity in the takeover area is over. I think that *Delaware* decision is, far more than most people seem to understand, is going to seriously inhibit large investors or companies from going after other large companies.

I think the game, to a great extent, is back to where it was, which is big companies can take over little companies, but little companies are not going to be able to take over large companies.

I'd like to just comment back on Senator Proxmire's comments about debt and equity ratios and perhaps introduce into the record Preston Martin's testimony on May 3 before the House Committee on Banking and Finance.

I've not had a chance to study the statistics, but it appears to me that they show that the debt levels have not risen over the past decade. They, in fact, have fallen. They did rise last year.

He comments that, in talking about recent stock retirements, that even though a large portion of recent stock retirements have been financed with debt, aggregate debt equity ratios for nonfinancial businesses as a whole, based on market values, have remained well below the peak reached in the 1970's.

There's an interesting group of statistics in there.

Senator D'AMATO. We'll accept that into the record.

[The following information was subsequently submitted for the record:]

STATEMENT BY PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I am pleased to appear before this Subcommittee to discuss recent merger and buyout activity and the impact of this activity on domestic credit flows and the safety and soundness of financial markets.

The dollar volume of completed merger transactions totaled over $120 billion last year, more than double the experience of any previous year (attachment 1). A substantial portion of this volume--more than $50 billion--was attributable to very large combinations, each involving more than $1 billion (attachment 2). So far this year we have continued to witness a substantial volume of acquisitions and proposed combinations. Although it is unlikely that all of the proposed mergers will reach fruition, the current volume is certainly large enough to warrant continued monitoring of market impacts.

As I have noted in recent testimony before other congressional committees, I believe that there is a legitimate place in our economy for mergers and takeovers. They can be important mechanisms for redeploying corporate assets to their most profitable--and socially beneficial--uses, and for bringing about better management. Thus, we must be careful about attempting to impose the judgment of governmental authorities about which private transactions will be economically productive and which will not. Nonetheless, government is obliged to do what it can to ensure that certain kinds of risk-taking do not jeopardize the stability of our financial system. From the perspective of the Federal Reserve, our concerns have focused on the effect that merger and takeover activity is likely to have on aggregate credit flows and on the risk exposure of financial institutions and markets.

Many of these merger transactions have been financed, at least initially, with debt. More than $15 billion of the 1984 volume represented leveraged buyout transactions (attachment 3), which typically rely on debt financing for as much as 80 to 90 percent of the purchase price, often using the assets of the company as collateral for the loans. Bank credit used to finance large mergers or defensive actions to avoid takeovers totaled an estimated $35 billion last year (attachment 4). About two-thirds of these loans were from U.S. banks, but foreign bank participation also was sizable. In the first quarter of 1985, large merger-related bank loans have totaled about $7 billion, with most of these loans supplied by U.S. banks.

Such credit is small relative to total credit outstanding at banks. Moreover, many merger-related bank loans are paid down fairly quickly with funds raised by sales of assets, or with proceeds from the sale of commercial paper or long-term securities. Thus, for example, approximately two-thirds of the large-merger bank loans extended in 1984 have been repaid. Nonetheless, the heavy reliance on debt, from whatever source, to effect the substantial number of mergers, takeovers, and leveraged buyouts raises questions about the potential impact that the transactions may have on aggregate credit flows and on the exposure, owing to heavy leveraging, of the firms involved.

The Board is aware of the influence of merger activity on aggregate credit flows, and takes it into consideration when evaluating the behavior of the money and debt aggregates. Growth in the domestic nonfinancial debt aggregate, which we monitor in the course of our monetary policy deliberations, is estimated to have been boosted by about 1 to 1-1/2 percentage

points in 1984 as a result of merger-related credit extensions. But mergers and buyouts appear to have had a much more limited impact on the three monetary aggregates for which we establish target ranges. The narrow money aggregate, M1, may be increased temporarily as a result of a large merger, but proceeds from merger sales generally are reinvested in other assets, and the effect of M1 tends to be small over periods of time relevant for monetary policy considerations. The broader aggregates, M2 and M3, may be boosted somewhat more than M1, as some proceeds from stock sales flow into time deposits, money market mutual funds, and other assets included in these aggregates. But relative to the size of M2 and M3, this effect also would be relatively minor. Given our ability to evaluate the size and timing of large transactions, we can anticipate possible distortions to the aggregates in a particular period and thus avoid inadvertently reacting to these factors rather than more fundamental determinants of credit demand in our policy deliberations. As a result, I do not believe that mergers present an operational problem for us that could cause appreciable unintended variations in reserve market pressures.

Assessing the implications of merger activity is quite complex, however, and even though we do not believe that debt-financed merger actvity has had a significant effect on aggregate credit flows, we are concerned about the potential risk exposure that may result as firms retire existing equity with funds raised through increased use of debt.

Last year, nonfinancial corporations retired more than $85 billion of equity through mergers, takeovers, and share repurchases. Equity retirements were bolstered also by firms that elected to repurchase their own

shares rather than undertake new investment or acquire other firms. Some share repurchases clearly were prompted as defensive measures taken to lessen the possibility of outsiders buying significant amounts of stocks; other repurchases were made because corporations find them to be a more profitable way to invest funds. When a company believes that the value of its assets is higher than the market's valuation of its stock, such buybacks may appear to be more attractive than alternative investments.

The unprecedented level of stock retirements associated with mergers, takeovers, and share repurchases has given rise to concerns about the potential erosion of the equity base of American business. There have been offsets, however, to this erosion. Aided by the new depreciation rules, after-tax earnings of nonfinancial corporations have rebounded strongly in the current expansion. With dividend growth remaining restrained, retained earnings have been a relatively substantial source of new corporate equity in recent quarters. A less important source of equity is new stock issues. Retained earnings of all nonfinancial firms offset the net retirement of stock, and net additions to equity in the aggregate remained positive last year though quite low by historical standards, especially during a business expansion.

Another source of equity growth has come from the appreciation of existing corporate assets. Reflecting the improvement in corporate profits in this expansion and a more favorable environment for future earnings, the market's evaluation of corporate assets has risen. Moreover, even though a large portion of recent stock retirements has been financed with debt, aggregate debt-to-equity ratios for nonfinancial business as a whole—based on

market values of equity—have remained well below the peaks reached in the 1970s (attachment 5). Nonetheless, while these aggregate measures have not changed dramatically, it is clear that some firms are retiring huge amounts of their equity and are taking on appreciable amounts of debt to finance merger-related activity.

The Federal Reserve, in its roles as supervisor of banks and bank holding companies and lender of last resort, has responsibility in conjunction with other regulatory agencies for maintaining the safety and soundness of financial institutions and markets. To date, we have seen no evidence indicating that the credit extended to finance mergers and leveraged buyouts has resulted in significant problems for the surviving firms or the financial institutions that have extended credit to them. Of course, our economy has been undergoing an expansion that has provided a favorable economic and financial environment for growth, and thus the companies created by recent mergers, as yet, have not been tested by adverse economic conditions. Currently, there are indications that economic growth may be slowing. Should the earnings prospects of these firms deteriorate unexpectedly, or interest rates rise sharply, some firms may be strained to service heavy debt burdens. In this event, the institutions that provided the credit could in turn be exposed to possible losses.

Leveraged buyouts may be of particular concern because these purchases typically are executed with particularly heavy reliance on debt financing. Because buyout loans often involve floating rate debt, the purchasing companies will be especially vulnerable in the event that interest rates rise substantially and cash flows are not adequate to service the heavy debt burdens.

The Federal Reserve has actively urged banks to evaluate carefully all loans, but particularly those used to finance buyouts and other types of takeover transactions, and to apply prudent standards in making credit decisions. We regularly include specific instruction with respect to the review of bank lending activity and loans associated with leveraged buyouts in our training courses for bank examiners. In June 1984, we offered additional training for dealing with leveraged buyouts for senior bank examiners. At about the same time, we issued specific guidelines for examiners at each of the 12 District Federal Reserve Banks to follow in evaluating loans for financing leveraged buyouts and for assessing the total exposure of a bank to such lending.

A recent review of the results of bank examinations indicated that only a small number of state member banks appeared to actively lend for purposes of effecting leveraged buyouts to the extent that they might be exposed to adverse changes in market conditions. No banks have experienced serious problems to date as a result of such lending. While these survey results suggest that there is little reason for alarm at this time, we will continue to evaluate this activity and to adjust our policies as needed. We encourage all lenders to apply prudent lending standards, particularly purchasers of low-rated or unrated bonds, which appear to have become popular vehicles for financing takeover attempts. Most of the purchasers of these so-called "junk bonds" that are used to finance merger activity reportedly are large, sophisticated investors who should be aware of the risks involved in holding such instruments. The higher rates paid on these bonds suggest that they are perceived to involve greater risks, but the question of whether the risk premiums will prove to be adequate to

compensate investors for the exposure they undertake remains unanswered in as much as the market has not been tested by significant negative events.

I do not wish to imply that lower quality bonds are undesirable financial instruments. These securities provide an important source of financing for many small, unknown companies. A new firm may have good growth potential, but because it, as yet, is untested, its debt issues likely will be rated below investment grade; some new companies opt not to obtain a rating owing to the cost involved and to the likelihood of being granted a speculative grade. It is important that less well-known companies be able to raise funds in securiites markets and important that investors seek a thorough understanding of the investment merits and risks associated with lower grade securities.

Federally chartered banks may make loans to finance mergers; they are prohibited from acquiring below investment grade bonds in their investment portfolios. However, some state-chartered institutions currently may not be subject to such restrictions. Indeed, some state-chartered thrifts have purchased these securities. Given the sensitivity of financial markets to the fortunes of individual institutions, we continue to encourage supervisors at both state and federal levels to evaluate carefully developments in this area and to take adequate steps to prevent undue exposure of individual institutions to unexpected events.

The Federal Reserve Board does not believe that arbitrary controls on the use of credit can be desirable or effective. Attempts to regulate flows of credit for particular purposes run the risk of creating unintended distortions in credit flows and impeding the efficient allocation of capital.

Since mergers can be important mechanisms for redeploying corporate assets to more profitable uses, promoting better management, economies of scale or scope, or reinforcing market incentives, we must be careful about imposing the judgment of governmental authorities concerning which private transactions will be desirable from a social and economic standpoint. When governmental controls on the use of credit are in existence for any length of time, they become increasingly inequitable as market participants find ways to circumvent them. And such controls are usually extremely difficult to enforce; since credit is fungible, most financing can be achieved through alternative channels, such as borrowing through unregulated intermediaries, from foreign lenders, or the like.

In this regard, I also would like to comment on the role of margin regulations as they may affect merger financing. Margin regulations apply to lenders making loans for the purpose of purchasing securities when those loans are collateralized with securities. Thus, investors that wish to purchase stocks on credit may, under current margin requirements, borrow 50 percent of the purchase price, and pledge the acquired stocks as collateral. The recent tendency for stock prices of target companies to rise when a takeover or merger is anticipated suggests that some investors may be purchasing shares of these companies in anticipation of realizing gains as the merger transactions are negotiated. Although we have no data on such individual stock trades, it may be that some involve margin credit extensions. The 50 percent margin requirement, we believe, is more than adequate to ensure the integrity of the market place in the event of unexpected price movements in these and other stocks.

Margin credit likely has played a quite limited role in the actual financing of mergers and takeovers. The margin regulations do not apply to unsecured loans or loans secured by assets other than securities. Well-capitalized companies may borrow to purchase shares in another company by pledging other types of assets as collateral or by using unsecured loans, in which case the lenders would not be subject to margin requirements. Given the current high margin requirements, there is a strong incentive for firms to use other means of financing acquisitions when possible. Unfortunately, there are areas in which the application of margin regulations is cloudy; in particular, questions have arisen concerning credit extended to purchase securities which may be "indirectly" secured by stock. These cases require a regulatory review to determine whether or not the extension of credit would be subject to margin requirements. As you may be aware, Federal Reserve staff currently are reviewing a petition to this effect by Unocal. Up to this time, the Board has not believed that efforts to curb takeover activity by expanding the scope of margin regulations to cover selected types of transactions has been a desirable option. Such a course runs all the risks of distorting capital flows and impeding the efficient allocation of resources like other selective credit controls.

I would like to reiterate that I do not wish to imply that we should be complacent about the implications of lending to effect mergers and buyouts. The Federal Reserve will continue to monitor this activity and its effects on financial markets, and review our examination standards in light of developments in this area.

Attachment 1

MERGER AND ACQUISITIONS OF U.S. CORPORATIONS[1]

Period	Number	Dollar volume ($ billions)
1967	1,800	$15.0
1968	2,440	28.0
1969	3,012	n.a.
1970	1,318	n.a.
1971	1,269	n.a.
1972	1,263	n.a.
1973	1,064	n.a.
1974	1,088	n.a.
1975	859	n.a.
1976	1,058	n.a.
1977	1,139	n.a.
1978	1,364	n.a.
1979	1,420	n.a.
1980	1,470	34.7
1981	2,231	72.4
1982	2,182	65.1
1983	2,191	50.5
1984	2,807	122.0
1985-Q1p	746	29.5

n.a.--not available.
p--preliminary.
1. Purchases of U.S. corporations by other U.S. companies and by foreign companies. Includes transactions valued at $1 million or more in cash, market value of capital stock exchanged, or debt securities. Partial acquisitions of 5 percent or more of a company's capital stock are included if the size requirement is met. Data shown for the number of transactions completed in the years 1970-79 exclude divestitures and foreign acquisitions. Divestitures or sales of subsidiaries, divisions, or product lines are included in dollar volume numbers.

Source: Mergers and Acquisitions magazine.

May 1, 1985

Attachment 2

LARGEST MERGER AND ACQUISITION TRANSACTIONS OF U.S. COMPANIES[1]

Acquiring company	Acquired company	Total price paid	Initial means of payment to selling stockholders		
			Cash	Stock	Debt
		millions of dollars			
1984					
Chevron	Gulf	13,300	13,300	--	--
Texaco	Getty Oil	10,120	10,120	--	--
Mobil	Superior Oil	5,700	3,800	--	1,900
Royal Dutch/Shell	Shell Oil	4,500	4,500	--	--
KMI Continental[2]	Continental Group	2,750	2,750	--	--
Beatrice	Esmark	2,725	2,725	--	--
General Motors	Electronic Data Sys.	2,500	1,900	600	--
Champion Int'l.	St. Regis	1,840	1,000	840	--
Dun & Bradstreet	A.C. Nielsen	1,300	--	1,300	--
IBM	Rolm	1,260	--	--	1,260
PACE Industries[2]	City Investing	1,250	1,250	--	--
American Stores	Jewel Cos.	1,150	817	333	--
JWK Acquisition[2]	Metromedia	1,130	825	--	305
Texas Eastern	Petrolane	1,040	1,040	--	--
TOTAL		50,565	44,027	3,073	3,465
1985					
Nestle	Carnation	3,000	3,000	--	--
Coastal	Am. Nat. Resources	2,460	2,460	--	--
Rockwell International	Allen Bradley	1,650	1,650	--	--
Textron	Avco	1,380	1,380	--	--
Chesebrough-Ponds	Stauffer Chemical	1,300	1,300	--	--
Pending:					
Turner Group	CBS	5,400	--	1,000	4,400
Capital Cities Commu.	ABC	3,500	3,400	100	--
Mesa Partners II	Unocal	3,400	3,400	--	--
Hospital Corp. of Am.	Am. Hospital Supply	2,400[3]	--	2,400	--
Cooper Industries	Mc-Graw Edison	1,400	1,400	--	--
Cox Enterprises	Cox Communications	1,260	1,260	--	--
Kohlberg, Kravis Group	Storer Commu.	1,640	1,240	400	--
Royal Dutch/Shell	Shell Oil[4]	1,170	1,170	--	--
Farley Industries	Northwest Industries	1,000	800	200	--

1. Shares in U.S. companies totaling $1.0 billion and over. Divestitures are excluded. Data are based on public information.
2. Leveraged buyout.
3. Valued as if American Hospital Supply were the acquired firm.
4. Final portion of Shell shares.

May 1, 1985

Attachment 3

COMPLETED LARGE LEVERAGED BUYOUTS[1]

Year	Buyouts of entire companies		Buyouts of divested units	
	Number	Volume ($ billions)	Number	Volume ($ billions)
1980	1	.5	n.a.	n.a.
1981	4	1.9	n.a.	n.a.
1982	10	2.7	n.a.	n.a.
1983	14	2.0	11	1.5
1984p	35	15.8	13	2.4

p--preliminary.
1. Includes transactions of $60 million and over for which public information is available.

Source: Federal Reserve staff estimates.

May 1, 1985

Attachment 4

LARGE MERGER-RELATED BANK CREDIT DEVELOPMENTS

	1984		1st Quarter 1985	
	Total (U.S. and foreign banks)	Estimated U.S. bank participation[1]	Total (U.S. and foreign banks)	Estimated U.S. bank participation[1]
	billions of dollars			
Estimated large credit lines arranged for potential acquisitions of U.S. nonfinancial corporations[2]	60.3	35.8	9.3	8.7
Merger-related loans taken down[3]	34.9	25.3	7.0	6.7
Memorandum: Total loans outstanding at all banks (excluding interbank loans)	—	1,329.4 (12/84)	—	1,347.3 (3/85)

1. Includes U.S.-chartered commercial banks, U.S. branches and agencies of foreign banks, and foreign branches of U.S. banks where known.
2. Includes credit lines for merger financing and takeover defenses arranged in 1984 by 21 companies in amounts ranging from $0.5 to $14.0 billion. First quarter 1985 figures include 10 credit lines in amounts ranging from $0.3 to $1.8 billion. Very large credit lines, such as those associated with the largest mergers in early 1984, require greater participation of foreign banks in part due to lending limits applicable to U.S. banks.
3. Amounts reflect estimated maximums taken down before repayments commenced. Substantial repayments (over two-thirds of the total taken down in 1984) were made by several borrowers using proceeds from sales in the commercial paper and long-term markets as well as from sale of assets. Three of the credit lines arranged for merger financing were not taken down in 1984, but one of these was used in 1985. Two of the credit lines arranged in the first quarter of 1985 have not yet been utilized.

April 30, 1985

Attachment 5

DEBT-TO-EQUITY RATIOS
NONFINANCIAL CORPORATIONS

Year	Debt(Par)[1] / Equity(Current)	Debt(Par)[2] / Equity(Market)	Debt(Market)[3] / Equity(Market)
	percent		
1961	41.1	38.5	35.3
1962	42.5	45.6	42.4
1963	44.5	41.7	38.9
1964	45.4	39.8	37.7
1965	46.5	40.0	37.7
1966	47.4	48.4	43.4
1967	48.7	41.3	36.4
1968	50.5	40.2	35.6
1969	50.3	50.3	41.5
1970	50.7	54.7	48.0
1971	50.7	50.0	46.7
1972	50.3	48.1	45.4
1973	48.9	67.7	61.9
1974	43.9	105.2	91.1
1975	41.6	79.5	72.0
1976	41.1	74.2	72.9
1977	41.4	87.6	84.0
1978	41.1	94.8	87.5
1979	39.9	88.7	79.0
1980	37.8	70.0	60.2
1981	38.3	82.7	70.0
1982	40.0	77.7	71.1
1983	40.6	69.2	63.3
1984	47.5	79.8	70.5

1. Debt is valued at par, and equity is balance sheet net worth with tangible assets valued at replacement cost.
2. Debt is valued at par, and equity is market value of outstanding shares.
3. The market value of debt is a staff estimate based on par value and ratios of market to par values of NYSE bonds; equity is market value of outstanding shares.

Source: Board of Governors of the Federal Reserve System, Flow of Funds.

May 1, 1985

Attachment 6

DOMESTIC BOND OFFERINGS BY U.S. CORPORATIONS IN 1984

	Total	Below investment grade[1]	
		Total	Merger-related[2]
	billions of dollars		
Public offerings[3]	63.6	16.1	6.5
Private placements	36.3	n.a.	4.3
Total[3]	100.0	n.a.	10.8

n.a.—not available.
1. Bonds with a rating of Ba1 or below or no known rating.
2. Bond offerings by corporations that had made acquisitions or repurchases of own stock within 12 months of the offering. Those offerings that specifically listed as a purpose of the issue the repayment of debt from mergers extending further back are also included.
3. Excludes mortgage-backed bonds.

May 1, 1985

Senator D'AMATO. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Joseph, sometime ago when you and I had a chance to meet and to talk at length about these issues, you said that something on the order of 90 percent of the companies in the United States would be considered as below investment grade in terms of debt instruments and, therefore, if you used the phrase, "junk bonds," to cover that whole universe, you're covering a very wide spectrum of kinds of situations.

I want to use that to pose a question to you, Mr. Rohatyn. And that is that on page 7 of your testimony, you say that it is in area of large takeovers that the junk bond phenomenon is particularly hazardous. I think you've taken great care to differentiate between some kinds of activity that you think falls within the normal bounds and some that create a new kind of condition that begins to add to an overall stress problem on the financial structure.

I'd like to hear your thoughts as to how we would make the definitional dividing line between those kinds of below investment-grade securities, or junk bonds, that would be acceptable and when we would cross over into a kind of junk-bond financing of a somewhat different sort that you would, at this point, find hazardous or unacceptable or having to be viewed and treated in a different way.

Mr. ROHATYN. Well, Senator, I'd like to divide this question into a couple of pieces.

My main concern with respect to, in effect, what are called junk bond financed raids are—I'd like to eliminate the ability of a raider who has some kind of a possible financing to be arranged with junk bonds out there, from making a tender offer, unless he has absolutely committed financing for 100 percent.

Now, that is my main concern here. If the financing is confirmed, if it is confirmed by the city bank or by some major institu-

tion, that the money is there, how he finances himself, whether he finances himself with junk bonds, with straight debt, that is another problem. So, in terms of market manipulation and not creating a speculative rate on a company that is simply started by somebody saying, gee whiz, maybe I can raise $5 billion and I'm going to put an ad in the paper and say, if I can raise $5 billion, I'll buy your company—I'd like to put a stop to that.

Senator RIEGLE. Yes; now, let me ask you, Mr. Joseph, in terms of the broad array of below-investment-grade securities, what percent would now be handled subject to financing and what percent would be handled according to this strict standard of the cash commitment or the credit commitment up front?

Do you have any kind of a rough sense for that? Is it 50/50, 90/10?

Mr. JOSEPH. Well, I'm having trouble breaking it down in the same way that I think I'm hearing the question. Let me try to talk at it for 1 minute.

Last year, as I indicated, very little of the high-yield bond financing done involved takeovers. This year, there's been about $1 billion out of what I think is probably about $7 billion which involved takeovers, and that was Coastal Corp's acquisition of ANR and Triangle Industry's acquisition of National Can. Those aggregate $1 billion.

The fact is every high-yield bond financing done resulted in commitments being taken down. And the advanced commitments are only applicable in the takeover area.

There's a sidebar in this question, which is, as a practical matter, every time there's been a subject of financing, as the deal progressed and it became appropriate to finance, the financing was raised.

As a mechanical matter, I don't know how you would go out and raise firm financing from a series of institutions to get ready to make a tender offer because you wouldn't be able to keep it a secret. And that's why we've fallen back on the technique of saying, subject to financing, once we're sure that we can do it, and then quickly going ahead and doing it, arranging it and getting the firm commitments.

It's just a question of controlling the dissemination of information and having leaks in advance of a corporate takeover.

Senator RIEGLE. Well, it sounds to me like we ought to immediately make the differentiation and we ought to take out of the broad umbrella the phrase, "junk bonds," below-investment-grade securities by companies that are in the normal course of business going out and raising funds for their own operation, and set that to one side. And then narrow the question down simply to these below-investment-grade securities that are being used for takeover efforts, and maybe even hostile takeover efforts.

I mean, that starts to narrow the universe down and I think gets it more into a manageable range for discussion.

Mr. ROHATYN. For the record, Senator, I would like to just differ with Mr. Joseph for a moment on the question of being able to secure firm financing without it leaking all over the place. It is a problem. It can be done. It's been done. It's done all the time.

Second, even though there was relatively little junk bond financing used in the actual takeovers last year, very large companies that ultimately were forced to merge were put in play as a result of raids that were financed or to be financed by junk bonds. And that included Gulf Oil. That included Cities Service. That included St. Regis Paper. That included Phillips Petroleum.

THREAT OF JUNK BONDS TIPS COMPANIES OVER

Now those are not de minimus companies. And so if the amount of junk bond financing that took place in takeovers was actually relatively small, the turnover of companies that occurred as a result of raids that were to be financed with junk bonds was extremely large. It was many tens of billions of dollars. And there, you have the dichotomy in this whole exercise, is that it is the threat of this type of financing that tips these companies over.

Senator RIEGLE. Well, you know, probably the most basic underlying principles of our securities laws involves the concept of fairness to all shareholders. And this starts to answer the question of Senator Hecht posed as to why there might be a public interest role here.

But in terms of insuring some measure of fairness to all shareholders, and I'm thinking here of both individuals, as well as institutions, are they now being treated fairly, in your view, in terms of the way the tender offers are taking place?

I'd like to ask you first and then get Mr. Joseph to respond.

Mr. ROHATYN. Well, I think Mr. Joseph and I agree completely on the tenor of this *Delaware* decision. I think the *Delaware* decision is a very troublesome decision in, in effect, allowing a company to discriminate among shareholders as to which stock it reacquires.

I think two-tier tender offers discriminate among shareholders as a practical matter because the professionals get out first and the smaller shareholder, who is not as sophisticated, remains behind.

You know, in England, you have a system which works extremely well. You have rules of the game that say if somebody's going to buy more than 25 percent of the company, he's going to make a bid for 100 percent at one price. And if a company is subject to a bid, it can engage in self-destructive tactics in order to foil the bid if the bid is at a fair price.

I mean, it's not that complicated.

Senator RIEGLE. Well, I think you're clear on that. Mr. Joseph, do you think that shareholders are being treated fairly now, the way this is structured?

Mr. JOSEPH. Not in all cases. I think, Mr. Rohatyn and I agree in most areas. I think two-tier offers are troublesome. You might be able to fix that by insuring that the second piece be at the same value as the first piece. The English system does work well in England, but I'm troubled by—it seems to me that you're taking a sledgehammer to kill a fly.

Senator RIEGLE. Well, let me ask you this——

Mr. JOSEPH. I don't think that our problems need that kind of dramatic change.

Senator RIEGLE. Do you think the SEC now, within its charter of authority, could take steps to deal with this problem which you both agree upon, or do you think that we would need to think in terms of some kind of additional legislative step to empower the SEC to do it?

Mr. JOSEPH. I think the SEC can deal with it. They have asked, I think, for some increased jurisdiction with regard to the so-called 13(d) window, which really needs to be closed or, in terms of sense of fairness, ought to be closed.

I'm not a lawyer and I'm not entirely sure how you attack that *Delaware* decision and whether that needs legislative intervention. I know that, I gather that the SEC is upset at that in terms of it's not something that they ever contemplated.

Senator RIEGLE. Mr. Rohatyn, in terms of the SEC forcing the tender offer rules, what's your feeling about that?

Mr. ROHATYN. I think the SEC has authority to enforce the tender offer rules. I don't know——

Senator RIEGLE. Are they doing so, in your view, sufficiently?

Mr. ROHATYN. Well, as I said, I believe the prohibition against making tender offers without financing is one that they could enforce by rulemaking. I think the issue of two-tier tender offers or having the second step at the same price as the first step is one that they could rule on.

On the question of discriminatory treatment of shareholders resulting from the *Delaware* decision, I don't know whether they need legislation or not.

On the question of allowing exchanges to list securities with very different voting rights, which is the direction that we're going in, I think they have rulemaking power. Certainly, the exchanges have the power to list or not list.

And then you have this new phenomenon of the Turner-type paper that is being registered. Whether to allow that kind of a registration to become effective is clearly within the power of the SEC to allow or not to allow.

Senator RIEGLE. Just one final point. And that is, as equity is being withdrawn, as we're increasing the leverage in a number of companies so that the debt-to-equity ratio is changing, do either of you have a sense in any aggregate way as to where the equity withdrawn seems to be going?

Now, obviously, that ends up in the hands of lots of different kinds of players. But is there any broad sense that either of you have as to where that equity is moving to?

Mr. JOSEPH. Let me try. I don't think either of us have done any studies, but not only is it being withdrawn, but very often withdrawn at greater value than it existed in the marketplace, that is, the premium over the trading price of the stock is also being given to the shareholders.

CASH REINVESTED IN THE STOCK MARKET

I would guess that the vast majority of that is being reinvested in the equity markets pretty clearly to the extent that in many of these cases, a very large portion of the stock was held by institutions. Those institutions are typically managing equity portfolios

and, to the extent that they sell a security or receive cash as a result of a tender offer, they are going to reinvest it in the equity market. Individuals will make their own decisions and I think, again, most people have a stock portfolio and receive cash for a stock—the first thought is to reinvest it in the stock market.

But that's just an assumption.

Senator RIEGLE. Would you like to add anything to that?

[Mr. Rohatyn nods in the negative.]

Senator RIEGLE. Wouldn't it be fair to say that for the institutional holders, if there's a successful raid on a company and the stock price is driven up and it's cashed out and whether the company later on is broken up in pieces or what have you, that in terms of the quarterly performance and the other periodic performance ratings for the investment companies, obviously are helped, I would think, by any windfall gain.

So they would have an interest, it would seem to me, just in terms of their own ongoing performance ratings to want to see more of this activity, would they not?

Mr. JOSEPH. I would think so. And, of course, very often, they're working on behalf of beneficiaries, whether they're pension funds, or insurance companies, or mutual funds.

Senator RIEGLE. It sounds to me like it tends to be sort of self-reinforcing at a certain point. In other words, within the big players, there are certain advantages that sort of move around in a loop here. You know, the question of when enough becomes too much, to get to the point that Felix is raising about a new kind of structural danger on top of a myriad of other problems that have been accumulating, that's a very important question. I'm not quite sure how we pin it down, although this discussion, I think, is very helpful.

Thank you, Mr. Chairman.

Senator D'AMATO. Senator Domenici.

Senator DOMENICI. Mr. Chairman, I don't want to impose on the committee members. I'm a guest. I'll go last.

Senator D'AMATO. Well, the Senator has another committee meeting and he's assured me that he's going to keep his——

Senator DOMENICI. I do. If the Senator doesn't mind, Senator Metzenbaum, I'll just take 2 minutes. I won't take my 5.

Is that all right with the Senator?

Senator D'AMATO. Senator Domenici.

Senator DOMENICI. Well, first, I do have a number of questions, but I'm not going to be able to ask them because of my own schedule. I am infringing on the committee. I'm not a member. But I would like to make a couple of observations.

First of all, it was interesting to read the Wall Street Journal. Their editorial pages for a couple of weeks had pretty good debates.

I might say to you, Mr. Joseph, I had no doubt in my mind whose side they would come down on. You won, in their eyes. But that doesn't amaze me, either, because when it comes to most of the things that I've been involved in, like reducing the Federal deficit, they've never been on my side either.

So I assume that there is some virtue in consistency.

Second, I really have been educated in this debate. I'm not a member of this committee, and I thought that financial insanity, to

borrow a couple of words from you, Mr. Rohatyn, was principally lodged in the Federal Government and its ridiculous deficit spending.

But the last month has permitted me to learn. It's been a very exciting education, and I've found that the high degree of spending does not only apply to the U.S. Government; we are not the sole culprits.

One of the justifications for takeover junk bond purchases by S&L's, which are effectively broke, even when you consider the insurance fund, is that, after all, they're making worse investments than that.

That's a marvelous approach, as I see it, to this problem. I think it offers all kinds of good policy suggestions for the Congress.

My conclusion is to change what you can in the current deplorable situation, and address other issues later.

But, in any event, although there are many issues, I'd like to focus on several points. I see the situation this way: what's happened in the last 4 years is that corporate America has had a rather substantial cash flow increase. This has occurred because of some changes in policy. Obviously, on the one hand, corporate America has a great deal of money. On the other hand, many firms are not using this money to benefit their stockholders which has resulted in our current problems.

TAXATION OF DIVIDENDS

It seems to me that, looking at this new tax reform, I would ask each of you, wouldn't it be a salutary approach to that phenomenon if we would address the issue of dividends and the taxation of dividends and deductibility of dividends?

I'm amazed that Treasury I had 50 percent deductibility, Treasury II has 10. Some say it shouldn't have any.

I think that changing the tax incentive which encourages corporate debt would impede the rash of takeovers that are occurring.

Am I thinking right? Either one of you, and quickly please, as I don't want to burden the committee.

Mr. ROHATYN. Senator, I think in the 1960's, where we did probably more takeovers by numbers than anything that I can remember since, 90 percent were done with equity. I think if you dealt with the dividend tax deductibility issue, you would increase the use of equity and mergers and acquisitions, which is clearly the way to do most of them.

Senator DOMENICI. Do you agree, Mr. Joseph?

Mr. JOSEPH. I agree with his comment, but also with yours, apart from his. I've not thought of it before, but it seems to me that it would be a constructive way to change that depressed equity situation.

Mr. ROHATYN. Senator, just to make you feel a little better about the Wall Street Journal, whose editorial I also read with interest yesterday about advocating free trade in takeovers, I would point out to you that the parent company of the Wall Street Journal, the Dow Jones Co., has probably some of the most restrictive anti-takeover provisions of any company around in multiple voting securities that guarantee family control. And for the Wall Street

Journal to advocate free trade in takeovers is like Playboy supporting virginity. [Laughter.]

Senator DOMENICI. Since the Wall Street Journal has excellent reporters, I don't want any of you to attribute any of this discussion to me. [Laughter.]

You have been generally objective. [Laughter.]

To the extent that that is attributable to your being paid well because of the restrictive policies, I really don't want you to attribute any of those statements to me. [Laughter.]

I just want to follow up with two questions. It appears to me that with the S&L's being in the condition that they're in, and I don't want to overemphasize what bad shape they're in, just for starters, wouldn't it be logical to restrict their participation in the limited area that we're speaking of? I'm aware of Senator Riegle's questions about companies using junk bonds to enhance their equity position as a matter of normal business. But wouldn't it be logical to at least begin by limiting federally insured S&L's in this area?

Mr. JOSEPH. High-yield bonds in hostile takeovers?

Senator DOMENICI. Yes, sir.

Mr. JOSEPH. I think it might be because of the rhetoric. The fact is the credits in the hostile area have been better credits. But in the real world, almost all the S&L's that had interest in that area have withdrawn because they just can't take the heat.

So I don't think that there's a need for legislation. I think the market is just—they've gone away from it.

Senator DOMENICI. Well, it was rather active, at least in California, for a while. One other question—should we be looking at the margin rules as they apply in these particular kinds of transactions?

Some people are telling us the margin rule, as I have learned is a phenomenon of the past, we don't need it any more. Yet, it applies rather dramatically to the average investor in the country.

Should we consider applying it to these kinds of transactions? Again, I'm talking only of the hostile takeover, junk-bond situation.

Mr. ROHATYN. Well, I think, Senator, if you accept the notion that some of these securities are closer to equity than to debts, then clearly, margin requirements are something that you want to look at.

One way or another, it seems to me, you want to create limitations on the amount of risks certain types of institutions can take. And whether you do that through the capital rules, through restricting the percentage of an institution's portfolio than can be invested in this type of security, whether you apply margin rules, that's a choice for the regulators.

But all of these can be used.

Senator DOMENICI. Thank you very much. Thank you, Mr. Chairman.

Senator D'AMATO. Thank you, Senator Domenici.

Senator Cranston.

Senator CRANSTON. I yield to Howard Metzenbaum, who was here before me. He's not a member of the committee, but a very interested Senator.

Senator METZENBAUM. I'm very grateful to my friend from California and to the chairman for affording me this courtesy. I will be rather brief.

Both of you have said that the *Delaware* decision is troublesome. I had spoken also of my own concerns about it in an opening statement, and that it may require legislation.

What would you think of a law that requires targets to get shareholder approval for structural changes in the company, such as selling the crown jewels or issuing new stock once a tender offer is announced?

Felix.

Mr. ROHATYN. Well, I've supported that, Senator, as you know, I think that companies that are targets of a tender offer should be limited in the actions that they take in defending themselves. But at the same time, I do think that the tender offers then should be structured in a way to eliminate some of the abuses that have taken place.

SOME BALANCE TO PROTECT SHAREHOLDERS

Senator METZENBAUM. So that, in other words, whatever legislation Congress considers or attempts to move on, you would agree, and I totally agree with you, that you need some balance to protect the shareholder, who, incidentally, has been very little mentioned. There's been very little mention of him or her in this hearing today. But it is he or she that I think needs the protection against abusive tactics on the part of the raiders, the greenmail, and some of the other procedures that occur, as well as protection from the corporate management, who uses various kinds of poison pills or other shark repellents in order to defend the entrenched management.

Mr. ROHATYN. I think what you have to do, Senator, is set up as level a playing field as possible, both for bidders and for targets, and put as many of the basic corporate decisions that affect corporate long-term structure back into the hands of the shareholders.

There are many things now that are left to the business judgment rule of directors. Some of them, I believe, really belong in the hands of the shareholders. This is, again, both as far as bidding companies and as far as target companies are concerned.

And as a director of a number of companies, I would welcome that. I'd much rather have the shareholders determine whether we're going to make a major structural change in a company than simply do it based on the business judgment rule and then find that maybe it wasn't such a great idea.

Senator METZENBAUM. And either in your statement or otherwise, I think you've indicated previously you support the concept of one share one vote.

Mr. ROHATYN. Yes, I do.

Senator METZENBAUM. Would you have any difficulty, Felix, in providing, as some have advocated, some exception, for companies that are not presently in that posture, and the second part of that question is for companies that are family controlled and owned and go public, with the understanding that the shareholders are really

not going to have any right to vote or to really participate in business judgment?

There have been some in the Congress who have indicated their feeling that there ought to be some exceptions for that which is.

Mr. ROHATYN. I think you might consider that, Senator. I also have no problems with different types of securities, like the securities that, for instance, General Motors is creating in their acquisition of Hughes and the acquisitions of EDS, where they created a different security to serve a particular purpose.

I think that's very imaginative, a very good idea.

In terms of family control, I would support probably some exception for companies that are coming into the public arena. But I would certainly limit the ability of companies going backwards.

Senator METZENBAUM. Yes.

Mr. ROHATYN. Namely, companies that are out there retrenching and creating inside control once they've been listed.

Senator METZENBAUM. I thank you and I think we're pretty much in accord on that.

Mr. Joseph, you heard my questions to Mr. Rohatyn. Would you be good enough to respond?

Mr. JOSEPH. It surprises me because I think that we would probably disagree on 96 percent of the specifics. But I agree with everything that Mr. Rohatyn said in this exchange. I think that one vote one share does make sense. I think there is an equal reaction to almost any action. And while I would applaud your thoughts as to keeping managements from entrenching themselves with tactics that erode values of a company, if you did too much of that, I think you tilt the playing field too far to the advantage of the raiders. I think that effectively, you've got a fairly balanced playing field at the moment and that there's need to improve and prevent some abuses on both sides, as you've discussed.

Senator METZENBAUM. Would you outlaw two-tier offers?

Mr. JOSEPH. No, I think I would opt for insisting that the second tier be at the same value as the first tier. But I don't get terribly exercised at the concept of perhaps outlawing two-tier takeovers.

Senator METZENBAUM. You wouldn't get terribly exercised at that concept.

Mr. JOSEPH. No, sir.

Senator METZENBAUM. Would you be willing to extend the waiting period to 60 business days?

Mr. JOSEPH. I think 60 business days is longer than necessary and it very substantially increases the real market risks of markets moving and the transaction just not being the same.

Senator METZENBAUM. Do you think that 10 days is too short?

Mr. JOSEPH. Yes—well, 10 days is 13(d). It's now 20. But I could see extending the 20 days to 30 days. I think the 20 is a little tight; 30 days would go a long way to ensuring fairness to the shareholders.

Senator METZENBAUM. How would you feel about requiring a bid for all the shares once the 21-percent threshold is reached?

Mr. JOSEPH. I think that isn't necessary. I think that would substantially change the way takeovers are analyzed and done and the probabilities of their occurring. And I'm not sure what the end result would be. I think, basically, we've got a market that's work-

ing fairly well and would not be in favor of that dramatic a departure.

Senator METZENBAUM. You have addressed yourself to the value of high-yield bonds, Mr. Joseph, and compare and say they're as good as low-yield bonds.

Well, that doesn't seem to be confirmed just by the market attitude. The reason they're paying high yields is because they can't be sold at lower yields.

So, I have some difficulty with that.

S&L'S INVESTING IN HIGH-YIELD BONDS

But that isn't the real thrust of my question. My question is you have spoken to the matter of thrift institutions investing in high-yield bonds and that that may give them sufficient yield so that subsequently, they're in a stronger position in order to deal with the more traditional real estate mortgages.

A query: If you permit thrifts to invest a substantial portion of their assets in high-yield bonds, are you not, in effect, providing that the Federal Government is underwriting those very securities through the FSLIC?

Mr. JOSEPH. Let me just touch on the first part of your comment.

It's interesting because, very clearly, the bond market provides a 300- or 400-basis point greater return for a high yield, as opposed to a high-grade bond.

From our point of view and the market's point of view, the reason for that is that, traditionally, institutional investors in this country, who buy virtually all the bonds, have been very risk-averse. And, as a consequence, there's been a market inefficiency where the premium they charge you for accepting an increase in perceived risk exceeds the actual economic increase in the risk. And that's why high-yield bonds have turned out to be an extraordinarily good investment, because you've gotten a bigger premium than you should have, and that comes around to why we think they might be good investments for thrifts.

Now——

Senator METZENBAUM. Go ahead.

Mr. JOSEPH. With respect to the second part——

Senator METZENBAUM. I don't want to take too much of the chairman's time.

Mr. JOSEPH [continuing]. Clearly, FSLIC guarantees S&L's, ultimately, the depositors. And that's why we think that some increase in the capital requirements for thrifts, especially those who wish to diversify their assets, would further strengthen FSLIC's position. It would give them a reason to increase their capital base so that they could increase the returns. That increased capital base is clearly FSLIC's insurance policy. It is at risk before FSLIC.

And I don't think that FSLIC should be insuring investments other than home mortgages. But it seems to me the way to do it is to increase the outside capital injected into the S&L and let the capital requirements then, give them space to go ahead and try to diversify and improve their return.

Senator METZENBAUM. Do you believe Congress should legislate in this entire area?

Mr. JOSEPH. No, sir; I think the areas I'm talking about with respect to S&L's could be regulated——

Senator METZENBAUM. No, not S&L's. I meant in this entire area of corporate takeovers, poison pills, two-tiers, greenmail.

Mr. JOSEPH. No; I think not, with the possible exception of trying to understand what can be done about and what are the implications of the *Delaware* decision. And I don't know whether that requires legislation or not.

If there's no other way to change that, then I'd be in favor of legislation in that one area.

Senator METZENBAUM. In that one area?

Mr. JOSEPH. Yes, sir.

Senator METZENBAUM. Would that be a little selfish on your part?

Mr. JOSEPH. I don't think so. My problem is——

Senator METZENBAUM. Wouldn't that just be to protect your position because Drexel Burnham has been so active in the takeover field? And aren't you totally forgetting about the rights of the shareholders who get short-changed on greenmail two-tiers, and other areas?

Mr. JOSEPH. Well, in fact, I'm opposed to greenmail, but I think it's past. I would not be at all opposed to legislation to prevent greenmail, but I don't think it's any longer necessary.

The fact is I'm—first of all, Drexel works on both sides in takeovers. That's been lost in the rhetoric about the big hostiles.

But I'm concerned about the implications of the shareholders of selective tender offers. It frankly goes beyond my ken as to what I expected was possible for companies and boards of directors and I may simply be having trouble digesting.

Senator METZENBAUM. Thank you, Mr. Chairman. Thank you, Senator Cranston.

Senator D'AMATO. Senator Cranston.

Senator CRANSTON. I appreciate the opportunity for us to hear from both of you.

The New York Times reported some time back:

> Some Wall Street executives are expressing their growing concern that the wave of corporate mergers in recent years has spawned a pattern of illegal insider trading in stocks of companies that receive takeover bids. Such trading, it is believed, has reached sizable proportions and, if allowed to continue, could tarnish the credibility of the securities market.

Since that story appeared, there's some evidence that more and more shareholders are concerned about insider trading that may be going on in corporate takeovers. Last week, the stock of Nabisco rose $8.37 in 1 day, and that was the date preceding the announcement of its merger with R.J. Reynolds, which has led to some speculation about that action.

Felix, you said:

> The growing feeling today is that the capital markets have become the property of insiders and of speculators, of raiders, and other professionals to the detriment of the general public.

To what extent do each of you believe that this feeling is a mistaken perception or is it, in fact, a reality? And if so, what should be done about it?

Mr. ROHATYN. Well, Senator, I think it's a reality. I don't know what you can do about it, frankly. I think the numbers are so large, the amounts of money involved are so big, the swings are really so dramatic. The reward for coming in early and being involved is so great, that I, frankly, don't know what you can do, except to, obviously, have as strong an enforcement as possible with respect to misuse of insider information.

You do have, as I said in my testimony, inevitable relationships between raiders and professional stock traders because they have mutually parallel interests. Once a raider takes a position in a company, whether he wants to buy the company or whether he wants to see it bought by somebody else, which is usually what he wants, his interests and the interests of professional traders are to see something happen to that company.

LIMIT THE ABUSES IN TAKEOVERS

So, it seems to me that the best way to limit the damage in this area is to limit the abuses on what can be done in takeover activity. To the extent you provide some ground rules to behavior, to what is legal behavior in a takeover and what isn't, you limit the temptation and the possible reward of very early speculative activity in a stock.

That plus as rigid enforcement as possible of the actual trading practices.

Senator CRANSTON. Do you feel that the SEC and the Exchanges are adequately on top of those problems presently?

Mr. ROHATYN. That's hard to say, Senator. You know, one of the side effects of technology is that information is available instantaneously all over the world, at any time of the day or night.

So you have extraordinary pressure to get information. You have, with respect to a lot of these takeovers, a lot of people have to get involved. You have teams of lawyers. You have teams of accountants. You have teams of bankers. You have teams of Xerox machines. You have all kinds of stuff floating around and an enormous premium on inside information.

I think it's a very serious problem and I can't give you any greater remedy than what I've suggested because I just don't know.

Senator CRANSTON. Thank you.

Mr. JOSEPH. I think it's a very serious problem, also. I think a great part of our securities markets are based on a public perception that they're fair. There is great evidence of insider trading in connection with takeovers.

I think the answer is not in changing the way takeovers are done. I think the answer has to be in very strong enforcement and increased penalties.

I know it is a high priority of the SEC and I think they're certainly trying to be on top of it. But the only thing I can think of is more enforcement people and larger budgets and larger penalties.

But we really have to maintain the perception of fairness in the market and there is a problem.

Senator CRANSTON. Do each of you believe that there's also a problem with the institutionalization of the market that has devel-

oped so strongly that the individual shareholder feels sort of left out of the action?

Mr. ROHATYN. I don't necessarily think that, Senator. I think that's probably an inevitable result of how money is accumulated in this country, where capital flows. And it flows into big institutions. A lot of individuals invest their money indirectly, whether it's through their pension funds, or their life insurance, or whatever.

So I think it may be regrettable in terms of involving as many people as possible directly with the capitalistic system through share ownership, but I think it's an inevitable result of institutional money flows in this country.

Mr. JOSEPH. I don't think it's a problem. I don't think, in fact, that institutional investors are, apart from this professional inside appearance resulting from the monstrous insider trading in advance of transactions—I don't think that the professional investors are in any way disenfranchising the public investors.

The fact is most of the institutions are investing on behalf of the public in one form or another.

Senator CRANSTON. It's been suggested that managers often make their decisions more in terms of what's best for them rather than what is best for the shareholders and that this takeover climate is causing them to pay even less attention to their shareholders.

How do each of you feel about those contentions?

Mr. ROHATYN. I think that, at least from what I've seen, Senator, I think that most managers spend most of their time thinking about how to best run their company in the interest of the company and the shareholders, as well as the employees and the customers.

I think that American management, by and large, has gotten a bum rap. Sometimes business is good, sometimes it's bad. I think that the people I've observed over the last 30 years, they work very hard. They hope to do very well. More and more compensation structures are based on share performance, so I think their interests are similar.

I think the problem with takeover activity, especially raids, is that it diverts a lot of management time to worrying about takeovers. It sometimes pushes managements to take actions that are short-term economic actions that are simply geared to make a takeover more difficult and less practical, and that, in the long run, have not necessarily beneficial aspects to the corporation, such as I believe some of these restructurings that are taking place today.

And I think management should not be in a position of having to worry about whether it's going to be taken over tomorrow in a decision as to whether a pharmaceutical company should keep up its level of R&D, for instance, or an electronics company should keep up its level of R&D, or an oil company should keep up some level of exploration drilling in terms of tomorrow's needs.

Now, you know, it's a fine line to draw. At the same time, you don't want management simply being able to interpose themselves between the board and their shareholders simply to keep a company independent at any price. I think that's ridiculous.

So, the line to draw is fine, but I think there's been a big change also in the composition and the attitude of boards of directors over the last 20 years. You have much more independent boards, you have independent committees, you have directors that are concerned about liability. And I think that's been a very, very positive force here.

Mr. JOSEPH. I think, like Felix and other investment bankers, we deal regularly with managements. The vast majority are sincerely interested in doing the best they can for the company and therefore, for the shareholders.

I think there are two areas where they sometimes get confused. One is in the heat of a takeover battle, where I think we've seen a lot of examples of managements doing things to win that battle and losing the war in terms of doing what's best for the company and, more importantly, its shareholders.

The other area where I've seen management struggle more than perhaps they should is when there's time to consider a major corporate restructuring, perhaps including a shrinking in the size of the company.

And, of course, something like the Arco transaction recently, or Mobil's taking a good, hard look at Montgomery Ward, are the kinds of things which I think are healthy and have been, in fact, maybe a favorable corporate response to the threat of takeovers. It's hard to decide to run a company half as big as the company you were running yesterday.

Except for those two specific areas, I don't see any reason to be concerned about management's capabilities or directions.

Senator CRANSTON. Chairman Shad has said:

> The threat of being taken over is an inducement to curtail research and development, plant rehab and expansion, and other programs, raising current costs rather than seeking long-term benefits.

Do you believe that that is an accurate assessment of what can occur?

Mr. ROHATYN. Well, as I said, Senator, I think that is a result of the threat of takeovers. At the same time, I think that you just can't take away totally the notion that companies belong to their shareholders and if somebody wants to make a bid for a company at a decent price and that treats all the shareholders fairly, they should be allowed to do that.

So, as in all things, you have to strike a balance. That's essentially what I was trying to say.

Mr. JOSEPH. I don't think that's a major problem. I'm surprised Chairman Shad said that. There was a study done by Greg Jarrell, who's the SEC economist, that, to the extent it could, discredited that concern, or at least proved that there was not much basis for that concern.

I would wonder if that's still Chairman Shad's view. I think he might have been asking the question as opposed to stating that as a conclusion.

Senator CRANSTON. Thank you both very much.

Senator D'AMATO. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman. I have an opening statement which I'd like to have submitted for the record.

Senator D'AMATO. So ordered.

[The statement of Senator Sasser follows:]

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman. Since our hearings here on April 3 and 4, a great deal has been added to the public record on the controversy over hostile corporate takeovers. Positions have been defined, data have been gathered, and the matter is continuing to receive a full airing in the press. I expect we will receive the benefit this morning of the past 2 months of public and private clarification of the issues at hand.

In the April hearings, I expressed my concerns to Federal Reserve Board Governor Preston Martin and Deputy OMB Director Joe Wright, about the potential threats to the stability of our economy represented by what has been called the leveraging of America. In 1984 alone, $90 billion was converted from equity to debt. Those threats extend to the viability of financial institutions and to public confidence in the market system. The underlying issue is a pivotal one: it is the issue of vulnerability—the vulnerability of a debt-based economy to an economic downturn. Those concerns remain, and they are part of the reason we are here today.

We are not here to decide whether to favor one type of institution or another, to determine whether corporate managements or investment bankers or raiders or any other industry leaders should be given any kind of advantage in takeover proceedings. Since passage of the Williams Act in 1968, it has been a matter of public policy that tender offer practices shall be conducted in such a way that neither side is favored. So that is not an issue. That has been decided.

And we are not here, as elected officials, to devise a means of insinuating ourselves into private market or business decisions that can and should remain in the private sector.

What we are here for, in my view, is to determine the best means of fostering a fair and equitable environment in which those private decisions can take place. And I think if we keep the shareholder foremost in our considerations, the principles of fairness and efficiency will naturally flow into any proposal we develop. If the shareholder is inadequately informed, if the shareholder's rights are abrogated, if the shareholder is disenfranchised, if the shareholder loses confidence in the system, there could be a very damaging and very long-term adverse impact on our market system.

I realize the majority of the transactions under review today take place at the institutional-investor level, but the shareholder principle—with all the corollary notions of fairness, rights and responsibilities that that implies—can be as well applied at the institutional level.

I look forward to hearing from our group of expert witnesses this morning, and to having the benefit of their counsel in this very complex, yet very fundamental issue in our national economy.

Mr. Joseph, the public is increasingly skeptical of the long-term benefits of some of these takeovers. It's been suggested that with

respect to one of the most recent attempts involving Unocal, the only people who finished ahead of the game were the short-term shareholders.

Now with respect to Unocal, what positive purpose, either economic or social, would you say was served by this exercise?

Mr. JOSEPH. I think you've really got to step back a little bit and understand, as I'm sure you do, the changes——

Senator SASSER. I'm not sure I do. Maybe you can enlighten me. [Laughter.]

DRAMATIC CHANGES IN THE OIL INDUSTRY

Mr. JOSEPH. The changes in the economics of the oil business have been very, very dramatic, as 20 years ago the changes in the steel industry were very dramatic. Refineries became uneconomical. Very few companies are successful, certainly in terms of costs to discover a new barrel of oil, successfully drilling for oil domestically. The rig count was down 50 percent from 1981–83 before we had our first of the major oil company takeovers.

So that the changes in the oil industry in this country were the result of the spike formation, OPEC, and the public and the automakers' reactions to that.

The reason I'm trying to make an analogy with the steel companies is there was no pressure on the steel company managements 20 years ago to reconsider their options, perhaps close major mills and go to minimill format, disinvest, or diversify.

That going along as you were down a straight track did not work.

The oil industry has been in a state of turmoil. The restructurings have been dramatic. Some companies have done them now voluntarily. Mobil's deciding perhaps not to stay with Marcor. It's been pretty well applauded by the investment community. It was hard to see how Mobil's shareholders were coming out ahead with that unsuccessful ongoing effort to run a large retailing operation.

I, in fact, think that reasonable men can differ and I don't know the answer. I think in 20 years, we'll have a feel whether Phillips' selling the North Sea Oil, merging Gulf and Chevron, the very good results that Occidental has had since it acquired Cities Service—I saw that yesterday they sold a new oil discovery, a participation for $1 billion. That has been, I think, a very successful combination. It eliminated a lot of duplication.

I think they are, case-by-case, very complex, and I don't think that anyone knows the answer to that.

Senator SASSER. Would you agree with that, Mr. Rohatyn?

Mr. ROHATYN. No, I don't think so, Senator. You were asking about Unocal. All I know is the basic numbers that I look at. You started this whole exercise with a company that was very strong, with very little debt. I think its stock was selling around $36 or $38.

You finish up the exercise with a company whose stock is selling at $31 with $6 or $7 billion of debt and in a considerably weaker position in terms of doing its business.

I must tell you that by no stretch of the imagination do I find anything positive in that exercise.

Senator SASSER. Well, Mr. Rohatyn, there's a former U.S. Senator by the name of Nicholas Brady that we all served with. We all developed a great deal of respect for Senator Brady.

He's now chairman of the investment banking house of Dillon Reed & Co., and he's been highly critical of today's takeover frenzy, as it's been characterized. Brady has said, and I quote:

> I oppose today's takeover frenzy financed by junk bonds, which increasingly endangers our savings institutions and our system of corporate enterprise.

Brady goes on to state his belief that:

> What is happening is similar in some ways to the speculative abuses that led to the 1929 crash and to the Chinese wallpaper craze of the late 1960's, when the financial scene was flooded with poorly conceived takeovers financed by convertible debentures.

And you, Mr. Rohatyn, have said, quoting you:

> We have to put the brakes on this go-go mania.

Continuing to quote:

> When we have too many people getting rich on mirrors, you have to stop and take a look at where we're going because it can all unravel.

I've got two questions. One, do you agree with Nick Brady's assessment that we may be seeing some of the same speculative abuses that led to the 1929 crash? And what are the mirrors you're referring to in your statement?

Mr. ROHATYN. Well, Senator, I think that Nick Brady and I are contemporaries. We grew up in the business together. I think we certainly share very similar views about this.

I hasten to add that both of us have made for many, many years, and expect to make for many more years, hopefully a very comfortable living negotiating mergers and acquisitions.

So that I would say to you, yes, I have the same concerns that Nick has. You know, when I talk about mirrors, I think that some of us, all of us, I guess, occasionally have a tendency to fall into more colorful language, maybe, than should take place in a financial debate.

Senator D'AMATO. Political debate, as I understand.

Mr. ROHATYN. I thought that was smoke, Senator. [Laughter.]

But I think when appearances begin to differ with reality more and more in terms of what risk is, in terms of what the capacity of a corporation to finance itself is, in terms of what the reality of life is all about with respect to the balance sheet of our financial institutions, that's what I mean by mirrors.

It's when the reality is not reflected by what you see on paper.

Senator SASSER. We've just gone through that with the banking industry down in my native State of Tennessee, I might say.

5-PERCENT THRESHOLD OWNERSHIP

One final question. A number of commentators have suggested that the threshold ownership of stock necessary for the filing of the schedule 13(b) could be reduced from 5 percent, so that the target of the takeover and its shareholders and the public are made aware of the accumulation of stock preparing for the takeover at an earlier date.

In other words, so that the warning or the storm signals can start flying earlier.

Do you believe that adopting such a rule and enforcing it would be helpful and would reduce to some extent the insider trading in the tender offer area?

Mr. ROHATYN. I don't think necessarily, Senator. I think that what you probably would do, if you lowered the threshold, you would create a lot more filings by people who might or might not be involved in a possible takeover. You would probably multiply manyfold the rumors that are already going around in the marketplaces to who's the next takeover candidate.

You would probably do more harm than good with that kind of an exercise.

Senator SASSER. It might stimulate more takeover——

Mr. ROHATYN. It would just stimulate more speculation.

Senator SASSER. What do you say, Mr. Joseph?

Mr. JOSEPH. I think I agree. I don't think that you're under any meaningful threat if a shareholder accumulates 2 or 3 percent as opposed to knowing when they get to 5.

I do think, and I've said before, that that 10-day window after you get to 5 percent during which you can accumulate as much as you want is dangerous. In the TWA situation, Mr. Icahn—everyone knew he was at 5, and by the time he filed, he was at 20 percent.

That's unfair and that's not what anyone contemplated in setting up the 13(b) 5-percent reporting rule. I think you would do more good fixing that than lowering the 5 percent.

Mr. ROHATYN. I agree with that, Senator.

Senator SASSER. One final question for you, Mr. Rohatyn. You said on page 5 of your testimony, and quoting again, that "bids that are made subject to financing," in many cases directly or indirectly financed by public bonds, picking up the quote, "permit the bidder to manipulate the market without committing himself to purchase."

Now, I thought market manipulation was a violation of our security laws. What leads you to believe that bidders are in fact manipulating the market in some of these takeovers?

Mr. ROHATYN. Well, it used to be, as a matter of fact, Senator, that, I believe, if I'm not mistaken, that the SEC had rules against making tender offers subject to financing because the practice itself was considered manipulative. That's what I'm talking about.

When you put an ad in the paper saying, I'm going to bid $5 billion for X,Y,Z Co., if I get the money, and all of a sudden, the markets start going crazy because people don't read the fine print or they don't know whether you've got the money or some think you might get the money or some think you might not get the money, that, in itself, to me is a manipulative device.

Senator SASSER. Gentlemen, thank you both.

Senator D'AMATO. Senator Eagleton. I might note that I think we've had three Senators who are not members of the Banking Committee or the subcommittee who have participated in today's hearings, which I think demonstrates the Congress and the Senate's very strong interest.

We're delighted to welcome Senator Eagleton.

THOMAS F. EAGLETON, U.S. SENATOR FROM THE STATE OF MISSOURI

Senator EAGLETON. I thank you, Mr. Chairman. This is the first time in 16 years that I've been in the Senate where I've ever asked the privilege of examining witnesses in a hearing before a committee of which I was not a member. But I'm keenly interested in this hostile takeover business, junk bonds, high-yield bonds, whatever they're called, and I asked your permission and you were very gracious in permitting it.

I have one question for Mr. Rohatyn and then I think four questions for Mr. Joseph.

Mr. Rohatyn, during the past month, I've written 40 letters to Wall Street investment bankers, major stock brokers, lawyers specializing in SEC work, especially hostile takeovers and the like. I even wrote you.

My letters asked for the recipient's opinion on junk bonds, hostile takeovers of airlines and networks, hostile takeovers in general, et cetera.

To the 40 letters, I've received 7 answers, 4 of which simply acknowledged my letter. So I was amazed at this code of silence that was out there.

I called on the phone one of the biggest names in investment banking, a friend of mine, a friend of yours, and he told me this:

> Tom, I'll talk with you on a not-for-attribution basis. Except for Rohatyn and Brady, and maybe a couple of others, you will get nothing but silence. And here's why. The old blue ribbon firms hold Icahn and his type in contempt. He's a slickster. Drexel has the raider business locked up. However, for every raider, there's a target company and the blue ribbon firms make a huge hunk out of defending target companies against the raider. Hence, although the blue ribbon firms inwardly can't stand the Carl Icahns of the world, they are nonetheless making money out of him. In the final analysis, Tom, money talks.

Question—Mr. Rohatyn, does that comment given to me over the phone from one of America's biggest investment bankers reflect the sentiment of the industry as you know it?

Mr. ROHATYN. Senator, I wouldn't hazard to speak for the industry. If I did, they'd probably run me out of town, anyway.

BIG BUSINESS DEFENDING AGAINST RAIDERS

It is true that we make money off other people's raids. Everybody does. We do. That's why I said earlier, this is a very big business for us—not financing raiders, but defending against raiders.

I can't tell you within my firm that the positions I've taken are viewed with equanimity by everybody. But, again, in the last analysis, money talks, and they let me say what I think. [Laughter.]

In every kind of situation of this kind, you're caught between the question, do you speak out against something that seems to be a problem, and is that counterproductive, because by speaking out, are you creating more of a backlash than you're trying to help? Or is it easier to work within the system without speaking out? Or is it easier to do nothing? Or is it very poor form to seem to criticize your colleagues?

People come down with different answers on these questions. I don't think people who refuse to speak out are in bad faith or cowards. I've had, I guess, the interesting experience of having half my

life in the public sector as chairman of the Municipal Assistance Corp. So I'm maybe a little more or a little less concerned with making public statements because I'm more used to it. And I have the scars to prove it.

So I think that's a very delicate question, Senator. I think it's very difficult to answer because it's very complicated.

Senator EAGLETON. Mr. Joseph, you were quoted in the Washington Post on April 30, 1985, about Ted Turner's offer for CBS as saying that your firm, Drexel, refused Turner's request to represent him in his takeover bid because Turner "is not perceived as being the kind of stable management you want running a highly leveraged, $5 billion enterprise."

Is that an accurate quote?

Mr. JOSEPH. Yes, sir.

Senator EAGLETON. Mr. Joseph, is there a difference insofar as the public interest is concerned, insofar as the question of fitness is concerned, in a hostile takeover of an airline or a network, for example, vis-a-vis some other industry that is not regulated by the Federal Government?

Mr. JOSEPH. I think there is a difference. I think there's a greater public interest in broadcasting and in an airline than in a widget manufacturer.

Senator EAGLETON. Now, getting back to stable management, you've represented Carl Icahn, have you not, in the following hostile takeovers: Phillips, Baird & Warner, Margage, American Can, Uniroyal, Anchor Hocking, Hammermill Paper, Owens Illinois, and ACF Industries.

Mr. JOSEPH. Absolutely not. We have represented him in only one hostile transaction. That was Phillips.

Senator EAGLETON. Oh, just the Phillips. All right. Do you currently represent him in TWA?

Mr. JOSEPH. No, we do not.

Senator EAGLETON. Did he seek your assistance in the TWA matter?

Mr. JOSEPH. I don't think he initiated a conversation, but I initiated a conversation where I told him that I didn't like that transaction.

Senator EAGLETON. All right. You told him you didn't like it.

Mr. JOSEPH. I did not like him making what looks like a raid or trying to acquire TWA. I didn't think it made sense from a financial point of view or a policy point of view.

Senator EAGLETON. It didn't make sense from a financial or policy point of view.

Did it make sense from the point of view of, since you were quoted as being concerned about who would manage a network and stable management, did it make sense insofar as stable management of TWA for Carl Icahn to manage TWA?

Mr. JOSEPH. I didn't focus on that. We have been impressed with his management of American Car & Foundry, which he has acquired.

Senator EAGLETON. Is that really a financial institution now?

Mr. JOSEPH. It is more of a financial institution.

Senator EAGLETON. Yes; so it's basically a financial institution today. What experience does Carl Icahn bring to managing an international airline?

Do you know?

Mr. JOSEPH. None that I know of, although——

Senator EAGLETON. But you'd be confident of his managerial skills?

Mr. JOSEPH. No, I didn't say that. He's a client and I've not had any reason to focus——

Senator EAGLETON. Well, he's an ex-client. He's not currently——

Mr. JOSEPH. He's not a client on this transaction, but our business is a business of transactions. We have a relationship with him and we think he's conducted himself with honor in those transactions.

Senator EAGLETON. At the outset of this hearing, my staff gave you an excerpt from the TWA filing before the Department of Transportation in which I think it was 12 various security violations of Carl Icahn were cited. And we asked that you peruse that document.

Have you done so?

Mr. JOSEPH. No, I haven't had a chance to.

Senator EAGLETON. Oh. Well, the point of the question was to give you a chance to peruse it and ask you if you and Drexel had represented him in any of those 12 transactions where he's been cited, paid fines, been enjoined, et cetera, either by the SEC or the State Corporation Commission of Virginia, or the New York district court.

It's an endless litany of 12—Chicago Board of Options, New York Stock Exchange, New Jersey Bureau of Securities, et cetera, et cetera, et cetera.

Don't you remember—do you remember any financial transaction in which Drexel Burnham was directly or indirectly involved, connected with one Carl Icahn, in which, as a result of that involvement, Carl Icahn, or the companies in which Carl Icahn was involved, paid a fine, was enjoined, or was in some way cited for contempt, or some other nefarious conduct before a commission, court, bureau, et cetera?

Mr. JOSEPH. Senator, I'm not trying to be cute. I don't know the litany. I'll be glad to look at it while we're chatting. I do not believe there's ever been a transaction in which Drexel——

Senator EAGLETON. I ask unanimous consent, Mr. Chairman, that written response from Mr. Joseph be requested, so as to give him a chance to study it——

Senator D'AMATO. I think that's only fair. I think what Mr. Joseph, sir, is indicating is that at this point, he certainly has no knowledge of that.

Senator EAGLETON. No, no.

Senator D'AMATO. But if we would submit him that list and ask him to respond in writing——

Senator EAGLETON. Yes.

Mr. JOSEPH. Certainly. I'd be glad to.

Senator EAGLETON. Fine.

[The following information was subsequently submitted for the record:]

DREXEL BURNHAM LAMBERT, INC., RESPONSE TO QUESTIONS BY SENATOR EAGLETON

Drexel Burnham was not involved with Carl Icahn in any of the transactions on the six-page list given to Frederick H. Joseph by Senator Eagleton at the hearing held by the Subcommittee on Securities on June 6, 1985 on corporate takeovers.

Senator EAGLETON. (i) On November 3, 1983, the SEC filed an action in the United States District Court for the District of Columbia, alleging that, an Icahn controlled company, Bayswater Realty & Capital Corp. (formerly B&W), had violated the federal securities laws by effecting and engaging in business as an investment company without registering with the SEC. The action was settled by the entry of a final consent order which enjoined Bayswater from engaging in transactions as an unregistered investment company and from taking certain other actions in violation of Federal law.

Mr. JOSEPH. No.

Senator EAGLETON. (ii) On September 16, 1983, Icahn & Co., entered into a consent order with the State Corporation Commission of Virginia with respect to charges that Icahn & Co. had transacted brokerage business in Virginia without first registering with the Virginia Commission. Pursuant to the settlement with the Virginia Commission, Icahn & Co. agreed to pay a monetary penalty.

Mr. JOSEPH. No.

Senator EAGLETON. (iii) On or about February 1, 1982, Icahn and others filed a Schedule 13D with regard to the securities of Marshall Field and Company. Marshall Field sued, alleging violations of the Federal securities laws and the Racketeer Influenced and Corrupt Organization Act. Marshall Field eventually obtained a temporary restraining order from the United States District Court for the Southern District of New York requiring Icahn and members of his investor group to correct various false and misleading statements in their Schedule 13D filings.

Mr. JOSEPH. No.

Senator EAGLETON. (iv) On December 30, 1981, the SEC filed an action against Icahn and his affiliates in the United States District Court for the District of Columbia, alleging various violations of the filing and disclosure requirements of the Exchange Act, including violations of the rules relating to proxy solicitations. Icahn entered into a consent agreement with the SEC at the time the action was filed in order to avoid prosecution of the claims raised against him.

Mr. JOSEPH. No.

Senator EAGLETON. (v) In mid-1981, after Icahn assumed control of B&W (later renamed Bayswater Realty & Capital Corp.), Icahn's management was the subject of a lawsuit brought by B&W's minority shareholders for breach of their state law fiduciary duties. The SEC also sued Icahn in connection with this transaction for violations of the disclosure obligations of the Exchange Act. The SEC's action resulted in the entry of a permanent consent injunction against Icahn.

Mr. JOSEPH. No.

Senator EAGLETON. (vi) In 1980, during his assault on Hammermill Paper Company, Icahn subverted the corporate electoral process, in violation of Federal law relating to proxy solicitations, by seeking to vote shares of Hammermill common stock which he did not own and which he had no right to vote, but had borrowed on the record date. When Icahn's unlawful scheme to vote these borrowed shares was finally uncovered, the shares were not counted, and Icahn lost the election. Icahn's proxy materials and related Schedules 13D and 14B statements with respect to Hmmermill were challenged by the SEC as violative of the Federal securities laws, resulting in a consent injunction being entered against Icahn.

Mr. JOSEPH. No.

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Mr. JOSEPH. No.

Senator EAGLETON. (viii) In June 1976, the State of New York issued an Assurance of Discontinuance, finding that Icahn & Co., for a period of 10 to 18 months, had employed three unregistered salesmen in violation of Section 359-e of the New York

General Business Law. Icahn & Co. agreed to pay a fine in settlement of these charges.

Mr. JOSEPH. No.

Senator EAGLETON. (ix) On January 30, 1976, the New Jersey Bureau of Securities issued a cease and desist order against Icahn, directing him to stop offering or selling securities in New Jersey until his brokerage firm, Icahn & Co., was properly registered in that state. The very next year, Icahn & Co. was charged with violating the Bureau's order and eventually entered into a consent order with the Bureau, pursuant to which, among other things, the company was assessed significant monetary penalties.

Mr. JOSEPH. No.

Senator EAGLETON. (x) In or after August 1978, Ichan & Co., without admitting or denying its guilt, also consented to a finding by the New York Stock Exchange that it had (a) violated Regulation 240.15c3-1 promulgated by the SEC under the Exchange Act relating to net capital requirements by permitting its net capital to fall below the minimum acceptable statutory level; and (b) submitted an inaccurate "FOCUS Report" to the New York Stock Exchange, reporting incorrectly, among other things, its net capital as of April 30, 1977. Icahn & Co. was censured and fined as a result of these violations.

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Senator EAGLETON. (xi) In October 1974, Icahn and Icahn & Co. admitted to violations of, and were found by the New York Exchange to have violated, Section 10(b) of the Exchange Act and New York Stock Exchange Rule 342, dealing with officers, approval, supervision and control. Both Ichan and Ichan & Co. were censured and fined for their violations.

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Senator EAGLETON. (xii) Since 1974, Icahn's brokerage firm, Icahn & Co., and its employees have been parties to four disciplinary proceedings commenced by the Chicago Board Options Exchange for alleged options trading irregularities. These proceedings were all settled by the payment of a significant fine.

Mr. JOSEPH. No.

Senator EAGLETON. I also want to ask unanimous consent that a speech that I gave on the Icahn matter with respect to his taking over of the Trans World Airlines be printed in the record at this point.

Senator D'AMATO. So ordered.

Senator EAGLETON. And I also ask unanimous consent, Mr. Chairman, that the full filing of Trans World Airline before the Department of Transportation relating to Carl Icahn and his attempted takeover of Trans World Airline be printed in the record at this point.

Senator D'AMATO. Without objection, so ordered.

[The following material was submitted for the record:]

News from Senator Tom Eagleton

U.S. Senate, Washington 20510 - 202/224-5721

FOR IMMEDIATE RELEASE:
THURSDAY, MAY 23, 1985

FOR FURTHER INFORMATION:
JON AUSTIN 202/224-5721

AIRLINES MUST OPERATE IN THE PUBLIC INTEREST, EAGLETON SAYS

In a strongly worded speech from the floor of the United States Senate, Senator Thomas F. Eagleton (D-Mo.) today charged that "Carl Icahn is not fit to run TWA and under law, the Department of Transportation should find that to be the case."

Eagleton delivered his remarks as he and his colleague from Missouri, Senator John Danforth (R-Mo.), introduced legislation that would require the Department of Transportation to take a more active role in the acquisition of airlines.

Eagleton noted: "At the very least, in vital, regulated industries such as communications and airlines, there must be a public interest that takes preference over pirate interest....If the Department of Transportation lets this tainted manipulator take over one of America's most important airlines, then that Department is as sleepy as the FCC is when it responds with a yawn as Ted Turner threatens to grab up CBS....The bill Senator Danforth and I are now introducing, albeit limited, would go a long way in giving DOT some spine and spunk in dealing with Carl Icahn."

In a separate statement accompanying the release of his remarks, Eagleton noted that as a Senator from Missouri, he was very concerned about the fate of the thousands of TWA employees in St. Louis and Kansas City should the Icahn bid succeed, but as an American he was equally concerned about the recent wave of corporate takeover mania.

Coinciding with the legislation introduced today, Eagleton delivered a letter to Transportation Secretary Elizabeth Dole urging her Department "to exercise any authority it may have under law, to protect the interest of the traveling public, TWA employees and shareholders, and the cities to which it flies from this questionable acquisition attempt."

In his floor speech, Eagleton closed by saying: "Can anyone believe that TWA will be better off, better operated in the greedy hands of Carl Icahn? Can anyone believe that the traveling public, the cities to which TWA flies, and its employees will be better served under the tender loving greed of Carl Icahn? Of course not. Icahn is a 14-karat pirate motivated by one instinct -- greed.

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For Immediate Release:

Senate Floor Speech by Senator Thomas F. Eagleton
United States Senate
May 23, 1985

The corporate world is basically conservative and rarely looks to the Congress for solutions. In spite of that bias, the latest rage in the business world -- uncontrolled corporate takeovers -- has brought some of the staunchest "free-traders" to testify before Congress in favor of legislative and regulatory remedies. Though some of my colleagues remain unconvinced that Congress has a role to play in this unpredecented round of corporate warfare, one sector -- namely those industries which operate as a necessary public interest -- demands our attention now before further economic havoc is wrecked.

I am pleased to join my distinguished colleague Senator Danforth as a co-sponsor of this legislation which has a limited, targeted focus, but is critically important as a first-step measure.

Nothing is static in America -- science advances, medicine progresses, and the law evolves. Even in stodgy old corporate America things change.

The biggest and newest change of all is the rise of the corporate takeover predator. Newspapers are filled with accounts of the attacks by men like T. Boone Pickens, Irwin Jacobs, Sir James Goldsmith, Saul Steinberg, and Carl Icahn seeking to gain control, wreck, or ruin various corporations in the interest of lining their own pockets.

Pickens "has a thing" for oil and has targeted among others Superior Oil, Philips Petroleum, and Unocal.

Sir James Goldsmith's targets included St. Regis Paper, the Continental Group, and now Crown Zellerbach.

Carl Icahn's previous victims include Phillips Petroleum, Baird and Warner Mortgage and Realty Investors, American Can, Uniroyal, Anchor-Hocking, Hammermill Paper, Owens-Illinois and ACF Industries, Inc. Now Mr. Icahn wants to grab up TWA to "run it" he claims; to ruin it many, including myself, believe.

Let's take a look at Carl Icahn.

According to the TWA application for a Department of Transportation fitness hearing, Mr. Icahn's corporate machinations and investment exploits have involved him in frequent violations of state and federal regulatory schemes, including numerous violations of the federal securities laws, which require complete and truthful disclosure of all material information for the protection of investors. Here are some of the items in that Icahn record:

(i) On November 3, 1983, the SEC filed an action in the United States District Court for the District of Columbia, alleging that, an Icahn controlled company, Bayswater Realty & Capital Corp. (formerly B&W), had violated the federal securities laws by effecting and engaging in business as an investment company without registering with the SEC. The action was settled by the entry of a final consent order which enjoined Bayswater from engaging in transactions as an unregistered investment company and from taking certain other actions in violation of federal law.

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(iii) On or about February 1, 1982, Icahn and others filed a Schedule 13D with regard to the securities of Marshall Field and Company. Marshall Field sued, alleging violations of the federal securities laws and the Racketeer Influenced and Corrupt Organizations Act. Marshall Field eventually obtained

a temporary restraining order from the United States District Court for the Southern District of New York requiring Icahn and members of his investor group to correct various false and misleading statements in their Schedule 13D filings.

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(x) In or after August 1978, Icahn & Co., without admitting or denying its guilt, also consented to a finding by the New York Stock Exchange that it had (a) violated Regulation 240.15c3-1 promulgated by the SEC under the Exchange Act relating to net capital requirements by permitting its net capital to fall below the minimum acceptable statutory level; and (b) submitted an inaccurate "FOCUS Report" to the New York Stock Exchange, reporting incorrectly, among other things, its net capital as of April 30, 1977. Icahn & Co. was censured and fined as a result of these violations.

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(xii) Since 1974, Icahn's brokerage firm, Icahn & Co., and its employees have been parties to four disciplinary proceedings commenced by by the Chicago Board Options Exchange for alleged options trading irregularities. These proceedings were all settled by the payment of a significant fine.

Can anyone believe that TWA will be better off, better operated in the greedy hands of Carl Icahn? Can anyone believe that the traveling public, the cities to which TWA flies, and its employees will be better served under the tender loving greed of Carl Icahn? Of course not. Icahn is a 14 karat pirate motivated by one instinct -- greed.

If the Department of Transportation lets this tainted manipulator take over one of America's most important airlines, then that Department is as sleepy as the Federal Communications Commission is when it responds with a yawn as Ted Turner threatens to grab up CBS.

Carl Icahn is not fit to run TWA and under the law, the Department of Transportation should find that to be the case.

This Administration -- with its complete laissez-faire attitude of "anything goes in the business world" -- has engendered the atmosphere in which takeover mania thrives with no anti-trust enforcement policy, with no regulation. This Administration's policies have created a playing field on which Pickens, Jacobs, Steinberg and Icahn can romp to their greed's content. No other Administration in history would have let these reckless profiteers, these wheeler dealers, run amuck. But Ronald Reagan and company sit passively looking on, benignly smiling as the predators create havoc in corporate America.

At the very least, in vital, regulated industries such as communications and airlines, there must be a public interest that takes precedence over pirate interest.

When will the Reagan Administration wake up? It is one thing to worship at the altar of Walter Wriston, David Rockefeller, and Lee Iacocca. It is another thing to worship at the pagan altar of T. Boone Pickens and Carl Icahn.

The bill Senator Danforth and I are now introducing, albeit limited, would go a long way in giving the Department of Transportation some spine and spunk in dealing with Carl Icahn.

Mr. President, I have written to Secretary Dole on this subject and ask unanimous consent that the text of that letter be printed at this point in the Record.

THOMAS F. EAGLETON
MISSOURI

United States Senate
WASHINGTON, D.C. 20510

May 23, 1985

The Honorable Elizabeth Hanford Dole
Secretary
Department of Transportation
400 Seventh Street, S. W.
Washington, D. C. 20590

Dear Madam Secretary:

I want to bring your attention to certain actions taken by Mr. Carl Icahn, this week, which emphasizes the need for immediate action by the Department of Transportation.

Mr. Icahn, on May 21, 1985 commenced proceedings to remove TWA's independent board of directors and to replace it with Mr. Icahn and two of his associates, through the means of a solicitation of written consents. Under Delaware law, where TWA is incorporated, stockholders may act without a formal meeting by executing a written consent to a particular action.

In view of this development, and the speed with which the consent process proceeds, it is imperative that the Department of Transportation act now to preserve the status quo so that it may investigate the serious questions regarding Mr. Icahn's potential control of TWA.

I want to urge the Department to exercise any authority it may have under law, to protect the interest of the traveling public, TWA employees and shareholders, and the cities to which it flies from this questionable acquisition attempt. I look forward to your earliest reply.

Sincerely yours,

Tom Eagleton

Thomas F. Eagleton
United States Senator

TFE/lmp

bcc: Honorable James Burnley
Under Secretary

angleton

BEFORE THE
DEPARTMENT OF TRANSPORTATION
WASHINGTON, D.C.

- x

APPLICATION OF TRANS WORLD AIRLINES, INC. ("TWA") FOR THE INSTITUTION OF AN INVESTIGATION ON ITS PROSPECTIVE CONTINUING FITNESS UNDER SECTION 401(r) OF THE FEDERAL AVIATION ACT IN THE EVENT CARL C. ICAHN SECURES CONTROL OF TWA AND FOR AN AMENDMENT OF ITS CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND OTHER RELIEF UNDER SECTION 401(g) OF THE ACT

DOCKET NO 43035

- x

SUBPART Q
(IT IS REQUESTED THAT THIS APPLICATION BE PROCESSED ON AN EXPEDITED BASIS)

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Counsel for Trans World
Airlines, Inc.

May 16, 1985

NOTICE: Any person may file an answer in support of or in opposition to this Application. Any such answer must contain a statement of that person's position and must be filed by June 13, 1985 or on such earlier date as may be specified by the Department of Transportation, with copies served on all persons served with this Application.

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BEFORE THE
DEPARTMENT OF TRANSPORTATION
WASHINGTON, D.C.

Application of	:	
TRANS WORLD AIRLINES, INC.	:	
for the institution of an investigation under Section 401(r) of the Federal Aviation Act of 1958, as amended, and for an amendment of its certificates of public convenience and necessity and other relief under Section 401(g) of the Act.	:	Docket No.

APPLICATION OF TRANS WORLD AIRLINES, INC. ("TWA") FOR THE INSTITUTION OF AN INVESTIGATION ON ITS PROSPECTIVE CONTINUING FITNESS UNDER SECTION 401(r) OF THE FEDERAL AVIATION ACT IN THE EVENT CARL C. ICAHN SECURES CONTROL OF TWA AND FOR AN AMENDMENT OF ITS CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND OTHER RELIEF UNDER SECTION 401(g) OF THE ACT

Trans World Airlines, Inc. ("TWA" or the "Company") submits this Application pursuant to Sections 313, 401 and 1002 of the Federal Aviation Act of 1958, as amended (the "Act"), 49 U.S.C. §§ 1354, 1371 and 1482, for an order (i) instituting an investigation on TWA's continuing fitness under Section 401(r) of the Act, should Carl C. Icahn obtain control of TWA, to operate

air transport services pursuant to its certificates of public convenience and necessity; and (ii) amending its certificates pursuant to Section 401(g) of the Act and granting other relief to prohibit Carl C. Icahn and the entities that he controls from utilizing their substantial equity position in the Company to force TWA to implement financial, operational and management changes that are contrary to the public interest and to TWA's continuing fitness obligations under Section 401(r) of the Act. In support of its Application, TWA alleges, upon knowledge as to itself and its own acts, and upon information and belief as to all other matters, as follows:

Preliminary Statement

1. On May 9, 1985, Carl C. Icahn and various corporations and partnerships which he controls (collectively, "Icahn") publicly announced their purchase of approximately 20% of TWA's outstanding common stock in a Schedule 13D filing with the Securities and Exchange Commission (the "SEC").* As averred in Icahn's Schedule 13D, Icahn is presently "considering" seeking control of

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* Two copies of Icahn's Schedule 13D are being submitted along with this Application to the Documentary Services Division of the Department of Transportation (the "DOT").

TWA and "may" seek to utilize his substantial equity interest in the Company (i) to influence TWA's management in the formulation and implementation of future policy; or (ii) to propose a leveraged buy-out or a merger or other business combination between TWA and ACF Industries, Incorporated ("ACF"), a company which Icahn controls.

2. Despite the precatory and tentative phrasing of Icahn's control intentions in his Schedule 13D, TWA believes -- based on Icahn's well-deserved reputation as a corporate "pirate," his history of aggressive actions toward companies in which he has invested, the "get-rich-quick" expectations of his co-investors, the economic factors attendant to his purchases of TWA shares, and the proposals and views that Icahn has expressed to TWA -- that Icahn <u>will</u> <u>imminently</u> seek to solidify his control over the conduct of TWA's business by means of further share purchases or otherwise. Indeed, in the many previous instances where Icahn has focused his attentions and investment activities on a target corporation there has never been a case, insofar as TWA is aware, where Icahn has been content to participate in the existing operations of the company as a passive long-term investor. Instead, he has subverted and divested

such businesses of their assets and operations, solely for his own personal gain.

3. This Application is necessitated by TWA's recognition that a holder of certificates of public convenience and necessity must, on an ongoing basis, be fit, willing and able to perform the air service authorized by its certificates and to comply with the obligations imposed by the Act. TWA believes that an Icahn-controlled TWA could not meet this standard for, among others, the following reasons:

(i) Icahn has demonstrated, beyond any fair question, a singular disregard for statutory and administrative regulation of his business activities. The SEC (on two separate occasions), the State Corporation Commission of Virginia, the State of New York, the New Jersey Bureau of Securities, the New York Stock Exchange (on two separate occasions), and the Chicago Board Options Exchange (on four occasions) have each acted to discipline or take other remedial action against Icahn or his companies for violations of applicable regulations. In short, Icahn does not have the re-

quired compliance disposition and in this regard is unfit.

(ii) Icahn and his associates, have no experience operating an airline and have no managerial competence or experience in operating an ongoing enterprise, other than in the field of securities investing. In this regard Icahn also is unfit.

(iii) Icahn has no sound financial plan to manage TWA and, in this regard too, an Icahn dominated TWA would be unfit. The "plan" that Icahn initially formulated and advanced to TWA was so barren of any financial responsibility that Icahn was forced to admit in his Schedule 13D that his plan was not feasible.

4. Accordingly, TWA is commencing this emergency proceeding so that the DOT may investigate Icahn and his interest in TWA and act to ensure that the Company not become unfit to hold certificates of public convenience and necessity. Given Icahn's ability to act swiftly to acquire control of TWA, it is important that this fitness issue be addressed now, before Icahn is in a position to exert operational and management control over

TWA and so that the interests of all concerned, including the public and TWA shareholders and employees, are protected.

5. TWA further believes that Icahn intends to utilize his equity interest in the company to cause TWA to implement one or more of the following schemes, to the detriment of TWA, its shareholders and employees, and the communities and consumers that TWA serves:

(i) the complete or partial liquidation of TWA's air transport operations, including the sale or abandonment of one or more of its domestic or international routes;

(ii) the abandonment of TWA's long-term plans for future growth and expansion, which TWA's present management believes are essential for the Company's future business and financial health and continued operations;

(iii) the drastic downsizing of TWA's labor force;

(iv) the replacement of TWA's existing, experienced management team with individuals who have no knowledge of TWA's business and no familiarity with the unique

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economic and business considerations applicable to the airline industry;

(v) the incurrence of massive additional debt and the diversion of TWA's income stream and resources away from the maintenance and improvement of TWA's existing equipment, facilities and operations for the purpose of paying back the debt associated with Icahn's acquisition of TWA stock and funding Icahn's other speculative investment activities, which will have the effect of jeopardizing TWA's continued viability; and/or

(vi) the sale of one or more of TWA's airplanes to (a) ACF or another Icahn-controlled entity at a price favorable to Icahn or (b) an unrelated company.

6. The implementation by Icahn of any one of the foregoing schemes would seriously disrupt TWA's operations and management, especially at the present time, when TWA is in the midst of sensitive contract negotiations with the labor unions representing its flight attendants and mechanics. TWA is also poised at the present time to commence contract negotiations with the labor unions representing its pilots.

7. More pertinently, Icahn's exercise of control over TWA for the purpose of implementing these schemes would also severely jeopardize TWA's ability to comply with the "continuing fitness" requirement of Section 401(r) of the Act. This requirement mandates that TWA remain "fit, willing and able" to perform properly the air transportation authorized by its certificates and otherwise to comply with the provision of the Act.

8. The fitness standard of Section 401 has been consistently interpreted to require that a certificated air carrier maintain (i) the managerial skills and technical ability to operate safely its air transport services, without undue risk of financial loss to consumers; (ii) a disposition to comply with the Act and the regulations imposed by federal and state regulatory agencies; and (iii) a capital structure and operational plan that generates sufficient resources to enable it to conduct its operations and to protect consumers. See, e.g., Chicago-Midway Low-Fare Route Proceeding, Order 78-7-40, July 12, 1978; Aeroamerica Fitness Investigation, Order 83-6-37, June 14, 1983; Spanish Main International Airlines Fitness Investigation, Order 81-11-86, October 1, 1981.

9. An Icahn-controlled TWA would no longer be in compliance with these fitness criteria and would not be able properly to carry out its air transport business to the detriment of TWA shareholders, employees, consumers and the public interest. TWA is therefore filing this petition with the DOT seeking:

(i) an immediate investigation and hearing under Sections 401(g) and (r) of the Act to investigate Icahn and the entities which he controls and to analyze Icahn's plans and intentions with respect to TWA and the impact that such plans will have on TWA's continuing fitness to carry on air service operations under its certificates of public convenience and necessity and otherwise to comply with the Act;

(ii) modification of TWA's certificates of public convenience and necessity to prevent Icahn from using his equity position in the Company to institute damaging changes in the capitalization, management, operations or structure of TWA that would be contrary to the public interest or that would render TWA unfit, unwilling and unable to per-

form the air service contemplated by its certificates or to comply with the provisions of the Act or the requirements thereunder; and

'(iii) directing other immediate relief in relation to Icahn, including requiring the divestiture of Icahn's TWA stock or the creation of an appropriate voting trust as a condition of the Company's continued operation as a certificated air carrier.

10. Because of Icahn's proven ability and inclination to act swiftly and decisively to carry out his destructive plans with respect to corporations in which he has invested, it is imperative that DOT act immediately to investigate Icahn and his intentions for TWA and take prompt steps to prevent Icahn from impairing TWA's fitness to comply with the Act and carry on its air transport operations. Accordingly, TWA respectfully requests that DOT institute an investigation and proceeding relative to this petition at the earliest possible date.

Statutory Framework

11. TWA's request for an investigation and hearing into its prospective continuing fitness under Icahn's control is clearly within the authority of the DOT under Section 401 of the Act.

12. Section 401(r) of the Act provides in pertinent part that:

> [t]he requirement that each applicant for a certificate or any other authority under this subchapter must be found to be fit, willing and able to perform properly the transportation covered by its application and to conform to the provisions of this chapter and the rules, regulations and requirements . . . [thereunder] shall be a continuing requirement applicable to each such air carrier with respect to the transportation authorized.

49 U.S.C. § 1371(r) (Emphasis added).

13. DOT is empowered by Sections 401(g) and (r) of the Act to instigate an investigation and conduct a hearing on an air carrier's continuing fitness under Section 401(r), and to "alter, amend, modify or suspend" a carrier's certificates of public convenience and necessity, in whole or in part, if the public interest so requires. DOT has invoked this authority on previous occasions to prohibit the involvement and exercise of control by particular individuals over an air carrier as a condition of granting a certificate of public conve-

nience and necessity. See Premiere Airlines Fitness Investigation, Inc., Order 82-5-11, May 5, 1982.*

14. The DOT is also authorized under the Act:

(a) "to perform such acts, to conduct such investigations, to issue and amend such orders, and to make and amend such general or special rules, regulations, and procedures," as it shall deem necessary to carry out the provisions of the Act and to perform its powers and duties thereunder. See Section 313(a) of the Act, 49 U.S.C. § 1354; and

(b) "to institute an investigation" with respect to matters within its jurisdiction, and to issue "appropriate" orders to compel compliance with the Act and/or the rules, regulations and requirements promulgated thereunder. See Section 1002(b)-(c)of the Act, 49 U.S.C. § 1482(b)-(c).

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* As granted, the certificate of public convenience and necessity for Premiere Airlines, Inc. provided, inter alia: "The holder shall prohibit Mr. Joseph Cicippio from exercising his voting interest from being a member of the board of directors or from holding a corporate office until [a specified time]." Certificate of Public Convenience and Necessity for Route 337 for Premiere Airlines, Inc.

15. The DOT is also empowered under Section 415 of the Act, 49 U.S.C. § 1385, "to inquire into the management of the business of any air carrier and, to the extent reasonably necessary . . . obtain from such carrier and from any person controlling . . . such air carrier, full and complete reports and any other information."

TWA

16. TWA is a publicly-held Delaware corporation headquartered at 605 Third Avenue, New York, New York. TWA is one of the largest airlines in the United States, employing more than 27,000 people and serving major metropolitan areas in the United States, Europe, the Mediterranean and the Middle East. In its domestic operations, TWA operates numerous daily scheduled flights between major east coast and west coast cities and to and from its hub in St. Louis, Missouri. TWA is also a strong competitor in the international air transport market. It has been entrusted with the responsibility of providing air transport services in a number of important limited entry foreign markets and has carried more passengers in scheduled air service between the United States and Europe than any other airline during each of the last five years.

17. TWA services its domestic and international routes pursuant to certificates of public convenience and necessity authorizing it to provide interstate, overseas and foreign air transportation of persons, property and mail on Routes 2 and 147.

18. TWA is a party to collective bargaining agreements with a number of labor unions including, among others, the unions representing its flight attendants and mechanics and related employees. TWA's agreements with these unions became amendable in July and October 1984, respectively, and the Company is currently engaged in sensitive negotiations seeking wage and work rule concessions. The collective bargaining agreement between TWA and its pilots union becomes amendable on June 30, 1985 and the Company will be commencing negotiations in early June of this year. The outcome of these negotiations is of critical importance to the Company, and TWA believes that the disruption of these talks would seriously damage its future competitiveness and profitability.

19. TWA operates a fleet of 159 aircraft and devotes a substantial portion of its resources to their maintenance and safety. TWA also devotes substantial time and resources to the ongoing training and education of the personnel associated with those maintenance activ-

ities, as well as to the continued training of its pilots and flight attendants.

20. As a result of airline deregulation, TWA was confronted with the need to reevaluate its business strategies so as to meet the demands of competition in a deregulated environment. As a result, TWA, on the basis of its own studies and considering the recommendations of respected, independent consultants, developed a strategy designed to create and maintain a vigorous airline, capitalizing on the synergies of TWA's preeminent North Atlantic route system and the domestic service provided through, among others, its New York and St. Louis hubs. In pursuit of this plan, TWA has acted to enhance its efficiency by simultaneously reducing the number of aircraft miles flown while increasing the number of passenger seat miles flown. Further, TWA has been successful in the restructuring of service levels among routes, sales of aircraft, the acquisition of new, more fuel-efficent aircraft, fuel conservation programs, personnel reductions, wage and salary reductions and improved productivity. TWA has also rescheduled, reconfigured and increased the utilization of its more fuel-efficient aircraft in an effort to increase the potential profitability of its fleet.

Icahn's Acquisition of TWA Stock
and Future Plans to Dismantle TWA

21. Beginning in or about December 1984, Icahn embarked on his scheme to acquire control of TWA and began buying TWA shares on the open market. Over the next four months, Icahn secretly increased his TWA holdings up to 5% of TWA's then outstanding common stock -- the level that triggered Icahn's obligation to make disclosures concerning his interest in TWA under Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act").

22. Icahn's TWA purchases were intentionally effected through a series of limited partnerships and closely-held corporations so as to avoid the pre-merger notice and waiting period requirements of the Hart-Scott-Rodino Antitrust Improvements Act and to conceal Icahn's interest in TWA from TWA, the market and the investing public.

23. Much of Icahn's TWA stake was purchased with borrowed money and he must pay interest on those borrowings at a premium rate. No dividend payments will likely be available to Icahn to help defray these interest costs as no dividend is currently being paid on TWA common stock. At least some of the money which Icahn borrowed to purchase his TWA shares appears to have come

from foreign banks, raising the possibility that an Icahn-dominated TWA would be controlled by a foreign citizen. See Premiere Airlines, Inc. Fitness Investigation, Order 82-5-11, May 5, 1982, p. 2.

24. During the last week of April, there was unusual activity in TWA stock, and rumors began circulating that Icahn was buying up TWA shares. On April 30, 1985, these rumors were fueled by news reports that Icahn was buying TWA stock and was interested in either (i) swapping his stock for TWA planes (which he would lease back to TWA or to another company through ACF); or (ii) forcing TWA to dispose of its lucrative international routes or its less profitable domestic operations to achieve short-term profit for Icahn and other TWA shareholders. Icahn publicly refused to comment on these rumors, but privately confirmed to at least one reporter that he was behind the activity in TWA shares and that he was interested in a stock for planes swap.

25. Coincident with the rumors that Icahn was interested in TWA, Icahn was purchasing large blocks of TWA stock on the open market. The bulk of these purchases -- three-quarters cut of the more than 20% that Icahn now holds -- were purchased during just ten days between April 29, 1985 (the date he crossed the 5% limit

and triggered his disclosure obligations under the Exchange Act) and May 10, 1985 (the date Icahn filed his Schedule 13D). Thus, by the time Icahn first publicly announced his investment in the Company on May 10, 1985 he had already amassed more than 20% of TWA's stock.

26. According to Icahn's Schedule 13D, Icahn's TWA stake is beneficially owned by a wide assortment of Icahn-controlled companies and partnerships, some of which appear to have been formed by Icahn for the express purpose of purchasing TWA stock. The individuals who are the principals of these entities -- which include Aero Limited Partnership, Cardinal Investors Corp., Longview Investors Limited Partnership, Ocelot Associates Corporation, Heron Investors Plan, Inc., Icahn Acquisition Corp., Excalibur Partners, ACF, I.C. Holding Company, Inc., Icahn Capital Corporation and Icahn Holding Corporation -- are not identified in Icahn's Schedule 13D, and TWA has no way of knowing their identity or citizenship.

27. TWA also has no way of knowing whether any of these Icahn entities have invested in the shares of other air carriers or common carriers or whether they otherwise have an equity interest in companies in the transportation industry. In the event that any of these Icahn entities controls an air carrier or a common carri-

er or a company substantially engaged in the business of aeronautics, Icahn's acquisition of TWA shares would be subject to DOT approval under Section 408 of the Act. In addition, Icahn may have arrangements or understandings concerning his TWA shares with another air carrier or company engaged in the transportation industry. Any such arrangements would raise serious questions regarding Icahn's compliance with Section 408 of the Act.

28. Despite Icahn's suggestion in his Schedule 13D of an interest in the long-term growth prospects of TWA, TWA believes that his true intention is imminently to seek control of the Company for the purpose of divesting it of its assets and diverting its operations and proceeds to Icahn's own personal use. Indeed, Icahn's suggestion of "investment intent" is wholly unbelievable in view of the substantial interest expense being incurred by Icahn, his stealthy acquisition of TWA stock and sudden appearance with a sizable equity position in the Company, his history of aggressive conduct toward companies in which he has invested, and the expectation of quick profit among his camp followers on whom he must depend to support his future investments.

29. Beyond question, the exercise of control by Icahn to achieve such short-term profit at the expense of TWA's existing and future operations would be contrary to the public interest and would seriously impair TWA's continued fitness to perform the air service contemplated by its certificates of public convenience and necessity and to otherwise comply with the requirements of the Act. In particular, Icahn's exercise of control over TWA could seriously undermine TWA's ability to continue to meet its international obligations under the Act and would at least create substantial uncertainty and confusion as to its continued ability to do so.

Icahn's History of Looting Corporations that He Controls and Poor Compliance Record will Jeopardize TWA's Continuing Fitness under Section 401(r) of the Act

30. Among the principal criteria for fitness under Section 401(r) of the Act is the requirement that a carrier be willing and able to comply with the requirements of the Act and have demonstrated an acceptable record in this regard. See, e.g., Aeroamerica Fitness Investigation, Order 83-6-37 at 5; Former Large Irregular Air Service Investigation, Docket 33363, P.I.D. No. 3 of Administrative Law Judge Rudolf Sobernheim, served July 20, 1978, at 18, adopted, Order 79-8-98, August 17, 1979.

A review of Icahn's record reveals that an Icahn-dominated TWA is unlikely to meet this test.

31. Icahn has achieved his considerable notoriety as a takeover entrepreneur and "greenmail artist" by exploiting improperly the corporate takeover process to achieve rapid short-term gain for Icahn and his affiliates, at the expense of the target company's other shareholders, employees and the domestic and international communities which it serves. Icahn's reputation for achieving such rapid speculative profits has attracted and is fed by a following of investors who finance his operations but require that he promptly effectuate his speculative schemes.

32. Icahn has employed a variety of tactics to extract quick profits from corporations in which he has invested, including utilizing his equity interest to force their complete or partial liquidation for his personal gain. In one recent and particularly flagrant example of this technique of corporate misappropriation, Icahn invested in and eventually acquired ACF, a company then engaged in a variety of manufacturing businesses. Following his acquisition of ACF, Icahn sold off several of ACF's operating divisions for the purpose, inter alia, of generating cash to fund his investment activities.

Icahn has since utilized ACF as an active participant in his investment schemes, including his present investment in TWA and his recent tender offer for Uniroyal Corporation. Icahn has also caused ACF to cut back its work force and has substituted himself for the previous independent trustee managing ACF employee retirement benefits.

33. Icahn implemented a similar looting scheme in 1978 in connection with Baird & Warner Mortgage and Realty Investors ("B&W"), a real estate investment trust. After obtaining control of B&W -- a feat that he accomplished within eight months of his first B&W stock purchases and despite his initial claim to have purchased B&W stock as a passive "investor" -- Icahn caused the company to terminate its status as an investment trust and to strip itself of its assets to generate cash for Icahn's other speculative interests. Icahn eventually converted B&W into an investment company which he used (as he uses ACF and the various other corporations and partnership interests that he controls) for the sole or primary purpose of carrying on his investment activities.

34. Even in those circumstances where Icahn has not actually achieved control, he has been able to force his corporate victims to sell off assets and to undertake other transactions that have provided Icahn with large profits at the expense of an ongoing corporate enterprise.

35. In the recent case of Phillips Petroleum Company ("Phillips"), for example, Icahn's "greenmail" tactics caused Phillips' management, in order to fend off what they considered to be a badly financed proposal, to invite its shareholders to exchange their Phillips shares for a package of Phillips debt securities. Icahn tendered his holdings and made a profit of more than $50 million. Moreover, he coerced Phillips into paying him close to $30 million dollars as "reimbursement" for his costs in exchange for his agreement not to seek to take over the company for a 10-year period.

36. . Phillips' actions in protecting the company against Icahn resulted in the tripling of the company's debt. In order to reduce this debt, Phillips will be forced to liquidate assets and substantially decrease the size of its operations. Moody's Investors Service noted that the Icahn-Phillips deal would "significantly weaken Phillips' financial flexibility."

37. Icahn's profit in Phillips mimics his success in other greenmail schemes, which have involved more than eight public companies to date. Among other targets, Icahn has directed his coercive tactics against the Tappan Company, Saxon Industries, Inc., Hammermill Paper Company, Simplicity Pattern Company, Inc., Marshall Field & Co., Anchor Hocking Corp., M.H. Lamston, Inc., Dan River Inc., American Can Co., Owen-Illinois, Inc. and Uniroyal, Inc.

38. Icahn has described his investment philosophy as follows in a confidential internal memorandum:

> It is our opinion that the elements in today's economic environment have combined in a unique way to create large profit-making opportunities with relatively little risk . . . . It is our contention that sizable profits can be earned by taking large positions in "under valued" stocks and then attempting to control the destinies of the companies in question by:
>
> a) trying to convince management to liquidate or sell the company to a "white knight";
>
> b) waging a proxy contest; or
>
> c) making a tender offer; and/or
>
> d) selling back our position to the company.

39. Icahn's corporate machinations and investment exploits have involved him in frequent violations of state and federal regulatory schemes, including numerous violations of the federal securities laws, which require complete and truthful disclosure of all material information for the protection of investors. These violations have led to the commencement of numerous legal proceedings and the entry of a number of consent decrees and judicial orders against Icahn and his affiliates:

(i) On November 3, 1983, the SEC filed an action in the United States District Court for the District of Columbia, alleging that, an Icahn controlled company, Bayswater Realty & Capital Corp. (formerly B&W), had violated the federal securities laws by effecting and engaging in business as an investment company without registering with the SEC. The action was settled by the entry of a final consent order which enjoined Bayswater from engaging in transactions as an unregistered investment company and from taking certain other actions in violation of federal law.

(ii) On September 16, 1983, Icahn & Co. entered into a consent order with the State Corporation Commission of Virginia with respect to charges that Icahn & Co. had transacted brokerage business in Virginia without first registering with the Virginia Commission. Pursuant to the settlement with the Virginia Commission, Icahn & Co. agreed to pay a monetary penalty.

(iii) On or about February 1, 1982, Icahn and others filed a Schedule 13D with regard to the securities of Marshall Field and Company. Marshall Field sued, alleging violations of the federal securities laws and the Racketeer Influenced and Corrupt Organizations Act. Marshall Field eventually obtained a temporary restraining order from the United States District Court for the Southern District of New York requiring Icahn and members of his investor group to correct various false and misleading statements in their Schedule 13D filings.

(iv) On December 30, 1981, the SEC filed an action against Icahn and his affiliates in the United States District Court for the District of Columbia, alleging various violations of the filing and disclosure requirements of the Exchange Act, including violations of the rules relating to proxy solicitations. Icahn entered into a consent agreement with the SEC at the time the action was filed in order to avoid prosecution of the claims raised against him.

(v) In mid-1981, after Icahn assumed control of B&W (later renamed Bayswater Realty & Capital Corp.), Icahn's management was the subject of a lawsuit brought by B&W's minority shareholders for breach of their state law fiduciary duties. The SEC also sued Icahn in connection with this transaction for violations of the disclosure obligations of the Exchange Act. The SEC's action resulted in the entry of a permanent consent injunction against Icahn.

(vi) In 1980, during his assault on Hammermill Paper Company, Icahn subverted the corporate electoral process, in violation of federal law relating to proxy solicitations, by seeking to vote shares of Hammermill common stock which he did not own and which he had no right to vote, but had borrowed on the record date. When Icahn's unlawful scheme to vote these borrowed shares was finally uncovered, the shares were not counted, and Icahn lost the election. Icahn's proxy materials and related Schedules 13D and 14B statements with respect to Hammermill were challenged by the SEC as violative of the federal securities laws, resulting in a consent injunction being entered against Icahn.

(vii) On or about November 29, 1979, Icahn and others filed a Schedule 13D with regard to the securities of Saxon Industries, Inc. stating that their stock purchases were made "for investment." They also said that board representation might be sought but that they had no other plans or proposals for the company. The SEC challenged certain of

these Schedule 13D statements as violative of the disclosure obligations of the Exchange Act, resulting in the entry of an injunction against Icahn.

(viii) In June 1976, the State of New York issued an Assurance of Discontinuance, finding that Icahn & Co., for a period of 10 to 18 months, had employed three unregistered salesmen in violation of Section 359-e of the New York General Business Law. Icahn & Co. agreed to pay a fine in settlement of these charges.

(ix) On January 30, 1976, the New Jersey Bureau of Securities issued a cease and desist order against Icahn, directing him to stop offering or selling securities in New Jersey until his brokerage firm, Icahn & Co., was properly registered in that state. The very next year, Icahn & Co. was charged with violating the Bureau's order and eventually entered into a consent order with the Bureau, pursuant to which, among other things, the company was assessed significant monetary penalties.

(x) In or after August 1978, Icahn & Co., without admitting or denying its guilt, also consented to a finding by the New York Stock Exchange that it had (a) violated Regulation 240.15c3-1 promulgated by the SEC under the Exchange Act relating to net capital requirements by permitting its net capital to fall below the minimum acceptable statutory level; and (b) submitted an inaccurate "FOCUS Report" to the New York Stock Exchange, reporting incorrectly, among other things, its net capital as of April 30, 1977. Icahn & Co. was censured and fined as a result of these violations.

(xi) In October 1974, Icahn and Icahn & Co. admitted to violations of, and were found by the New York Stock Exchange to have violated, Section 10(b) of the Exchange Act and New York Stock Exchange Rule 342, dealing with officers, approval, supervision and control. Both Icahn and Icahn & Co. were censured and fined for their violations.

(xii) Since 1974, Icahn's brokerage firm, Icahn & Co., and its employees have been parties to four disciplinary proceedings commenced by by the Chicago Board Options Exchange for alleged options trading irregularities. These proceedings were all settled by the payment of a significant fine.

40. In view of the foregoing history of diverting the assets of targeted corporations for his own personal benefit and disregarding the rules and regulations of the SEC and of various state regulatory agencies, it is apparent that Icahn's exercise of control over TWA would seriously threaten the Company's continued fitness under Section 401(r) and its continued ability to comply with the requirements of the Act. See, e.g., Regent Air Corp. Fitness Investigation, Order 83-6-106, June 23, 1983, at 15 (noting, with regard to principals of an air carrier who had agreed to a consent injunction brought by the SEC, that "[t]he fact that the SEC felt strongly enough about these concerns to file a formal complaint casts a shadow over" the carrier's compliance disposition); Spanish Main International Airlines Fitness Investigation, Order 81-11-86, October 9, 1981 (finding that a disposition to comply with state and federal laws

and regulations is a prerequisite to a determination of a carrier's fitness).

The Exercise of Unfettered Control by Icahn is Likely to Adversely Affect TWA's Managerial, Operational and Financial Fitness

41. In addition to a compliance disposition that evidences a willingness and an ability to comply with the Act, a certificated air carrier must demonstrate ongoing managerial and operational expertise, as well as the financial capability and responsibility to perform the air service contemplated by its certificates of public convenience and necessity and to operate its air transport business safely and efficiently. See, e.g., Northeast Sunrise Airlines, Inc. Fitness Investigation, Order 83-5-90, May 19, 1983.

42. Up until now, TWA has complied fully with these requirements. It has assembled a capable management team and has implemented a detailed operating and financial plan sufficient to permit the maintenance and improvement of TWA's existing equipment and air transport operations. If Icahn is permitted to exercise unrestrained control over TWA, however, the Company's continued ability to comply with these standards will be severely threatened.

43. As noted supra, Icahn and his affiliates have previously demonstrated a disregard of regulatory and statutory requirements and an indifference to financial and managerial responsibility. For example, Icahn's brokerage company, Icahn & Co., has consented to a finding by the New York Stock Exchange that it violated SEC regulations governing net capital requirements. These net capital requirements are designed to protect the financial interests of the investing public and are an essential part of the SEC's system of financial safeguards in the securities industry.

44. Icahn & Co. has also been censured by the New York Stock Exchange for employing salesmen who were not registered with the appropriate regulatory authority and for not registering with officials in states where it was conducting a brokerage business. Moreover, after merging ACF with I.C. Acquisition Company in 1984, Icahn discontinued several of ACF's operating divisions, and indicated that investments to be made by ACF might result in greater benefits to Icahn and his affiliates than to ACF itself.

45. Ultimately, deprivation of adequate funds poses a risk to air safety, which is one of the paramount responsibilities of the DOT in administering the provisions and requirements of the Act. See Section 102(a)(1) of the Act, 49 U.S.C. § 1302. Concern regarding safety is especially acute here since, to TWA's knowledge, there is no publicly available financial information for Icahn or any of the entities that he controls other than ACF.

46. At a minimum, before Icahn is permitted to take actions with respect to TWA that could jeopardize its continuing financial fitness under Section 401(r) and, potentially, the safety of its operations, Icahn should be required to file with DOT complete and accurate financial and other information with respect to himself and the entities that he controls.

47. TWA also has concerns about the lack of managerial or operational expertise of Icahn and his associates and their total lack of experience in the airline industry. Consideration of this lack of experience is plainly relevant to a determination whether TWA would be unfit following Icahn's acquisition and exercise of control. See, e.g., Northeast Sunrise Airlines, Inc. Fitness Investigation, Order 83-5-90, May 19, 1983, p. 4 (the business history, judgment and management skills of

a chief executive officer are relevant to fitness of air carrier that he manages); Spanish Main International Airlines Fitness Investigation, Order 81-11-86.

48. Icahn himself has only a minimal history of managing an operating business and has no known experience in the aeronautics industry. Indeed, as demonstrated by his history described above, Icahn's interests and skills lie in the area of investment and speculation rather than the operation and management of an ongoing concern. On those occasions when Icahn has taken control of a company, he has demonstrated little interest in dealing with his acquisition as other than an investment vehicle.

49. In short, Icahn's record to date is devoid of any evidence demonstrating his managerial or operational competence or suggesting that Icahn himself possesses, or is likely to hire managers possessing, any understanding or operational experience in the airlines industry. To the contrary, Icahn has already demonstrated his unfamiliarity with the management of an airline by proposing, and then publicly abandoning on the grounds that it was economically unfeasible, a plan to discontinue some of TWA's domestic operations and to sell off the planes utilized for those routes. Icahn now claims to be

contemplating a number of other equally unfeasible strategies for TWA, including a leveraged buy-out of the Company or a sale of its international routes. This lack of knowledge, coupled with Icahn's poor compliance history and consistent pattern of investing in companies solely to turn a quick dollar, demonstrates that he is unfit to be entrusted with the control of a large air carrier like TWA with substantial public service obligations, particularly in the international area.

50. The one strategy that Icahn is not willing to pursue is to manage TWA in a competent, responsible manner or to maximize the long-term interests of TWA, its public shareholders, its employees and the travelling public. Accordingly, he should not be permitted to exercise unfettered control over TWA.

WHEREFORE, for the reasons set forth above, TWA respectfully requests that the DOT:

(i) institute a continuing fitness investigation under Section 401 of the Act with respect to Icahn and the entities that he controls to determine and analyze Icahn's plans and intentions with respect to TWA and the impact that such plans will have on TWA's continuing fitness to carry out domestic and

international air service operations under its certificates;

(ii) order a modification of TWA's certificates of public convenience and necessity to prevent Icahn from using his equity position in the Company to institute changes in the management or financial or operational structure of TWA that are contrary to the public interest or that would render TWA unfit to perform the air service contemplated by its certificates;

(iii) prohibit Icahn from acquiring any additional shares of TWA stock unless and until authorized to do so by the DOT; and

(iv) direct other relief with respect to Icahn, including requiring the divestiture of Icahn's TWA stock or the creation

of a voting trust for such shares in order to prohibit the use thereof by Icahn.

Dated: May 16, 1985

Respectfully submitted,

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Counsel for TRANS WORLD
AIRLINES, INC.

50-673 O—85——27

VERIFICATION

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

C.E. MEYER, JR., declares as follows:

1. I am the President and Chief Executive Officer of Trans World Airlines, Inc., the party filing the annexed application.

2. I certify that I have read the foregoing; that to the best of my knowledge, information and belief, every statement contained therein is true and no such statements are misleading; and it is not interposed for delay.

C. E. Meyer, Jr.
C.E. Meyer, Jr.

Subscribed and sworn to
before me this 15th
day of May, 1985

Barbara T. Bryant
Notary Public
BARBARA T. B...
Notary Public, State of ...
Qualified ... County
Commission ... 86

Certificate of Service

I hereby certify that on the 16th day of May, 1985, copies of the annexed Application of Trans World Airlines Inc. were served by hand on the following persons and entities:

Carl C. Icahn
1370 Avenue of the Americas
New York, New York 10019

Aero Limited Partnership
1370 Avenue of the Americas
New York, New York 10019

Cardinal Investors Corp.
1370 Avenue of the Americas
New York, New York 10019

Longview Investors Limited Partnership
1370 Avenue of the Americas
New York, New York 10019

Ocelot Associates Corporation
1370 Avenue of the Americas
New York, New York 10019

Heron Investors Plan Inc.
1370 Avenue of the Americas
New York, New York 10019

Icahn Acquisition Corp.
1370 Avenue of the Americas
New York, New York 10019

Excalibur Partners
1370 Avenue of the Americas
New York, New York 10019

ACF Industries, Incorporated
750 Third Avenue
New York, New York 10017

I.C. Holding Company, Inc.
1370 Avenue of the Americas
New York, New York 10019

Icahn Capital Corporation
1370 Avenue of the Americas
New York, New York 10019

Icahn Holding Corporation
1370 Avenue of the Americas
New York, New York 10019

Steven J. Barnes

Senator EAGLETON. And I thank you for your courtesy, Mr. Chairman.

Senator D'AMATO. Let me at this point ask if there are any other questions? We do have three other panels.

We've had, and I don't know whether Mr. Rohatyn or Mr. Joseph would like to make any remark or leave this committee with any thought, but let me say at this point that I am deeply appreciative of the time that both of the gentlemen have taken, of the incisiveness of your observations, your responses to our questions, the preparation that went into your presentations.

I can tell you from one perspective, and I know that Senator Proxmire shares in this, that you have both made a very meaningful contribution to this area. This area is fraught with emotion, as we're talking about corporate governance. We're talking about stockholders, preservations of their interest, and they run high in these areas. And I'm very appreciative of your expertise and the fact that you've made them available to this committee.

Are there any other questions of this panel? Do you gentlemen have any concluding remarks?

[No response.]

Senator D'AMATO. We're deeply appreciative.

Mr. ROHATYN. Thank you.

Mr. JOSEPH. Thank you.

[Response to written questions of Senator Proxmire from Fred Joseph follows:]

Drexel Burnham Lambert Incorporated
Response to Questions by Senator Proxmire

Drexel Burnham Lambert is one of the leading full-line securities and commodities firms in the United States and the second largest private investment banking firm in terms of capital. Drexel's emphasis is to provide financial services to growing companies and to be at the forefront of the development of innovative financing techniques. In this regard, Drexel has played a major role in developing a market for high yield debt securities. High yield bonds include all issues rated below "investment grade" -- those which are rated Bal or lower by Moody's, BB+ or lower by Standard & Poor's or unrated.

Effects of Potential Defaults

The size of the public market for currently outstanding high yield straight debt is approximately $60 billion. High yield bonds accounted for approximately $14 billion of publicly-placed financing in 1984, or approximately 22% of all corporate bond sales during the year. Since all publicly traded straight corporate debt outstanding as of the end of 1984 totaled approximately $425 billion, the high yield segment represented approximately 14% of the total.

Historically, the default rate in the public bond market has been low and the few major defaults (such as International Harvester and W.T. Grant) have not caused a significant disruption in that market. The same is true for the high yield bond market, which is merely a subset of the larger public market for corporate bonds. This is because high yield bonds trade based on the unique performance characteristics of each issuer. Investors evaluate bonds on a case-by-case basis and independently analyze the quality of each security. A default by one or more issuer(s) therefore should not affect the marketability of the securities of other issuers with different performance characteristics. Given the depth and breadth of the secondary market for high yield bonds and the prudent investment standards investors apply in evaluating these securities, the secondary market should remain strong even in the event of one or two defaults.

Effects of Economic Downturn

High yield bonds have proven to be a sound investment for savings and loan associations with well diversified portfolios because they offer premium returns at risks comparable to more traditional investments. Given the track record of high yield bonds, Drexel does

not share the concerns expressed by others that high yield bond portfolios are unusually sensitive to economic downturns. Even during 1980-1981 when the nation faced the deepest recession since the Great Depression, the number of defaults among both new high yield bond issuances and leveraged buyouts financed by bank debt was not significant. Based on this performance record, Drexel does not anticipate the occurrence of a number of major defaults even in the event of a recession.

It is worth noting that high yield bonds offer certain advantages over commercial loans that reduce potential losses. If a higher grade bond is downgraded after it has been purchased by an S&L, the savings institution can sell the bond to other investors who specialize in the higher risk/lower grade segment of the high yield bond market. Through this process, S&L's are able to limit their losses and control their risk of default. This market liquidity function makes high yield bonds a more attractive investment for S&L's than traditional commercial loans, for which there is not a highly liquid secondary market.

It also should be noted that because bond holders take precedence over equity owners, in the event of

default it may be the case that bondholders lose only a portion of the value of their investment.

In any event, it is not instructive in evaluating the high yield bond market to simply count the number of past defaults or to try to predict the probability of future defaults. An analysis of risks associated with high yield bonds is relevant only if it measures potential return against the risk of default. Various risk/rewards studies have concluded that the premium returns offered by high yield bonds more than offest the risks. Even with a tripling of the 0.52 percentage point default rate, investors would still earn an annual yield of almost 1.75 percentage points above U.S. Treasury securities of comparable maturity. This premium return is especially significant when compared to returns on investment grade bonds or more traditional loans which have experienced difficulty. Accordingly, Drexel believes that an S&L holding a diversified portfolio of high yield bonds will be adequately protected in the event of an economic downturn or resurgence of high interest rates.

Historic Market Performance is Relevant to Future Performance

Critics have argued that prior studies are not a reliable indicator of future performance due to the rapid growth of the high yield bond market in recent years. However, the increasing credit quality of high yield bonds undercuts this criticism. A recent study by Morgan Stanley has shown, for example, that in 1977, the average BB/B debt-to-total-capital ratio (with equity stated at market value) was 62.2% and had declined to 51.5% by 1984. Studies have also shown that the average issuer's net worth has increased from $64 million to $323 million during the last five years. Other studies have shown that during each of the past five years, a greater percentage of high yield bonds of a higher grade have been underwritten than in the previous year, with more than 42% of all high yield bonds underwritten in 1984 being rated BB as compared to 21% in 1980.

Conflict of Interest Concerns

Like law firms, accounting firms and commercial banks, investment banking firms must be sensitive to the potential for conflicts of interest which could arise from the representation of different clients.

Drexel has on occasion represented Carl Icahn in connection with high yield bond financing. We also recently served as the investment banker for TWA. The fact that Drexel may have represented in the past an individual who subsequent to such representation becomes engaged in a different transaction in which his interests are now at variance with another client does not in and of itself raise a conflict of interest. Rather it is what one does when presented with a situation wherein the potential for a conflict exists. Drexel shares your concern that representation of both sides in a disputed transaction could, and probably would, give rise to a conflict of interest. Moreover, Drexel would, of course, be concerned if there is a misperception that Drexel represents both sides in a transaction. As an investment banker, Drexel's success hinges upon its service, its professionalism and its integrity. Accordingly, Drexel has established internal policies and procedures to prevent conflicts of interest from occurring.

Every transaction in which Drexel is involved is screened by an underwriting assistance committee as well as by Drexel's executive committee. In addition, the top management of Drexel are in daily contact with one another. As a rule when two existing clients become

engaged in an unfriendly transaction, Drexel's policy is to cease representing the acquiror and represent only the potential acquiree. Therefore, Drexel did not represent Carl Icahn in his attempt to take over TWA. In continuing such representation, as in any other representation, Drexel adheres to what we believe are the highest standards of conduct.

Identification of Investment Opportunities

It is common practice among investment bankers to notify clients when an attractive investment opportunity is identified. That is how stockbrokers and investment bankers earn their living. While it is not often easy to identify attractive investments, undervalued stock is an important factor to be considered. Thus, when Drexel becomes aware that the stock of a company is selling for less than its potential value, it may pass that assessment on to potential investors. It is more often the case, however, that clients will approach Drexel and request our assessment of the potential for investment in certain companies or classes of companies.

One must keep in mind, however, that Drexel does not create situations such as the Phillip's takeover. Rather, takeovers occur because current management has failed to maximize the value of the company and the

marketplace believes company assets can be used more efficiently by different management. These situations will continue to occur whether or not Drexel provides financing. The fact that more acquisitions are financed by investment grade bonds than by high yield bonds and the fact that only a very small percentage of all high yield bond issuances are used for hostile acquisitions lend credence to this conclusion. The ability of Drexel and other investment bankers to identify companies with undervalued stock and to assist in arranging acquisition financing, however, ensures that management will continue to act in the best interests of company shareholders.

Insider Trading

Insider trading is a serious concern for any institution with access to insider information, including corporations, law firms, accounting firms, commercial banks and investment bankers. In handling acquisition transactions, Drexel does not engage in or tolerate insider trading and has established internal policies and procedures to ensure that its personnel (and their relatives) do not do so either. Drexel's policies and procedures are applied firm wide. The Corporate Finance Department is the division which is primarily responsible for advising clients in connection with acquisition-type

activities and structuring transactions. Department personnel are not to discuss a pending deal with anyone outside the department and are only to discuss it with others in the department who have a need to know. The Corporate Finance Department meets regularly to discuss administrative and policy matters and the firm's policy on insider trading is periodically reviewed as appropriate to ensure compliance. In addition, the Corporate Finance Department conducts a trainee program for new associates in which these policies, as well as the legal aspects of insider trading, are thoroughly covered by representatives of the Corporate Finance Department and the Legal Department.

Pursuant to advice of the Legal Department, the firm has established internal mechanisms to protect against insider trading. First, the Legal Department periodically meets with other departments to discuss insider trading and to review Drexel's internal policies and procedures. Second, the Legal Department maintains the lists of restricted securities. The first list, or the so-called "visible" list, is circulated to all appropriate Drexel offices and departments each day. In addition, each registered person also has access to the restricted list through the Quotron System. Once a securi-

ty is placed on the list, all activities in such stock are curtailed. There can be no solicited buy or sell orders by Drexel brokers; Drexel officers, directors, employees and their relatives may not trade in the securities; nor can there be any proprietary trading or discretionary trading in the securities for Drexel's account. In addition, there can be no recommendations by Drexel's research department or changes in Drexel's rating of a security while it is on a restricted list.

It is an unfortunate fact that outside arbitrageurs often learn when a security has been placed on an investment banking firm's visable restricted list. Accordingly, where secrecy is important (a developing situation which cannot yet be made public) the visable restricted list is not employed. Instead the securities in question are placed on a nonvisible restricted list maintained by the Legal Department. That department notifies a control in Research and those select firm proprietary traders on a "need to know" basis to avoid conflicts through inadvertance. Drexel's retail system is not apprised (to do otherwise could destroy secrecy) and thus may handle trades in these securities. The Legal Department reviews the retail system's trading runs daily, however, to insure that secrecy has in fact been main-

tained. Thus, Drexel believes that it has developed a satisfactory "Chinese Wall" between the Corporate Finance Department and the retail system to ensure that any trading of securities is not a result of insider information. To further ensure the effectiveness of the "Chinese Wall", the Corporate Finance Department does not interact with the retail system, is located in a separate building and maintains a separate administrative system, security system, filing system and library. While Drexel is confident that its internal procedures protect against insider trading, it periodically reviews all policies and procedures to ensure its compliance with the federal securities laws.

Senator D'AMATO. Thank you.

[Pause.]

Senator D'AMATO. We're deeply appreciative of the fact that our panelists on our second panel have been as patient as they have been. We certainly apologize to both of them—the comptroller from the city of New York, my dear friend, Harrison J. Goldin, who does an outstanding job, and my good friend and associate, Muriel Siebert, former superintendent of banking of the State of New York, the first woman to hold a seat on the New York Stock Exchange.

We apologize for the delay and we're appreciative that you've taken of your time to share with this committee your thoughts on this issue.

Comptroller Goldin.

STATEMENT OF HARRISON J. GOLDIN, COMPTROLLER OF THE CITY OF NEW YORK, COCHAIRMAN OF THE COUNCIL OF INSTITUTIONAL INVESTORS

Mr. GOLDIN. Thank you very much, Mr. Chairman.

I appreciate the opportunity to help further the national debate on how our society should respond to the seeming epidemic of hostile corporate takeover attempts and defensive reactions by management.

My special interest in the subject derives from my duty to preserve and enhance the value of billions of dollars' worth of assets that are entrusted to my fiduciary care. As the elected comptroller of the city of New York, I am the custodian and/or asset manager of five actuarial pension systems, with more than 400,000 members and aggregate assets exceeding $23 billion, a sum expected to exceed $50 billion within the decade.

At present, $7.8 billion, or 33.8 percent, of total current assets is invested in equities, the common stock of more than 1,200 American corporations.

HEAVY COMMITMENT TO BUSINESS HEALTH OF AMERICA

That is a heavy commitment, giving us a large stake in the business health of the country, making us a significant owner of corporate America, with a keen interest in the long-term well-being of the firms we partly own. And of course, we have a profound interest in various mergers and attempted acquisitions, unfriendly and otherwise, and their real and potential impact on the value of our assets.

While I speak today for the pension funds under my jurisdiction, I am also one of three cochairmen of the recently formed Council of Institutional Investors. The council comprises 22 pension funds across the country, with combined assets exceeding $100 billion. That represents 25 percent of the asset value of all public pension funds in America and nearly 7 percent of the $1.5 trillion estimated aggregate of all institutional portfolios, both private and public.

The council is principally a vehicle for the exchange of information. As fiduciaries, its members do not and cannot delegate their trusteeship. But on matters in which we all have a stake, it is helpful to us to be able to exchange and receive information that will enable us better to make independent decisions in given corporate finance situations.

The council was established in late January as a direct response to both real and potential asset value losses arising from certain defensive actions by managements to thwart attempted hostile corporate takeovers. These include greenmail, golden parachutes, poison pills, the issuance of new stock to insiders to dilute outstanding shares, creation of two classes of common stock with differing voting strengths, indeed, any action designed to frustrate acquisition of control or more by outsiders and to entrench existing management permanently, thus making them virtually unaccountable to the shareholders, the real owners of the companies involved.

What has been the council's response? By and large, the members agree on at least three guiding standards that I, as New York City Comptroller, endorse, too:

One, corporate takeovers are neither good nor bad in themselves.

Two, the presumption is that two-tier treatment of shareholders is damaging to our beneficiaries.

Three, the creation of two classes of common stock with varying voting strengths is damaging to our beneficiaries and bad for the American economy.

Let me elaborate a bit on each of these points:

One, mergers and acquisitions—corporate takeovers, if you like—are neither good nor bad in themselves. They must be considered on a case-by-case basis, with each asset manager determining what is best for his or her beneficiaries.

Some takeovers are bad: they do not offer the prospect of maximization of a company's assets through orderly long-term growth. But some are good: they fulfill given investment objectives and

narrow the disparity between a company's asset value and the market price of its stock. So there is no ethical imperative to legislate takeovers out of existence or necessarily restrict their frequency or scope.

When a so-called corporate raider makes a tender offer and management reacts defensively, it is up to each shareholder and potential investor, collectively comprising the marketplace, to determine whether the raid or the defense will maximize their interest. We believe that that judgment is invariably far sounder than one made by Big Brother or any other institutional substitute.

Accordingly, the answer to the question of how society should respond to the takeover phenomenon is to ask rhetorically: Whose company is it, anyway? It is surely not management's; nor is it Government's. The company belongs to its owners, the shareholders.

It is, therefore, the shareholders' prerogative to make basic policy decisions about the direction of a corporation and its disposition: whether it should or should not be sold; whether it should be taken over or not; whether its management should be retained or replaced.

Shareholders, like anyone else, may make mistakes, and if they do, they will get their just desserts; but when their decisions are sound, they will be rewarded in the time-honored coin of capitalism—profit.

Clearly, legislation to restrict mergers and acquisitions would simply substitute the judgment of Government for the judgment of shareholders as collective owners of companies. And that would frustrate the free market.

Further, legislation restricting mergers and acquisitions would, paradoxically, ultimately not protect shareholders, either; essentially, it would restrict their opportunity to maximize the value of their investments. I want that opportunity for the pension systems I manage and not to have it restricted by statute or replaced by the discretion of Government bureaucrats.

I do not want to be misunderstood. I and institutional investors like me are not short-term traders, looking for quick windfalls. We are not speculators. We do not ipso facto side with corporate raiders against managements.

We are long-term investors, whose participation in the Nation's security markets furthers the essential purpose of such markets; namely, to facilitate capital formation in the interest of growth and a fuller realization of the value of assets. I and other members of the Council of Institutional Investors have sizable holdings in literally thousands of corporations; and our general interest is in the long-term growth of all corporate America. Indeed, by and large, when we invest, we invest in management, confident in its day-to-day stewardship.

DISCRETION OF SHAREHOLDERS FOR FUNDAMENTAL DECISIONS

But we want to retain for ourselves as shareholders discretion to make fundamental decisions about our investments. We want the opportunity to determine for ourselves whether an unfriendly takeover attempt is good or bad for our beneficiaries. We do not want

that opportunity taken away from us by either Government, through legislation, or the veil of the so-called business judgment of the managements of firms in which we own stock. Those managements should be obliged to secure our consent before erecting barriers calculated to frustrate reasonable offers, whether invited or not, for all or part of our stock.

Government's role should essentially be to prosecute fraud. And since mergers and acquisitions are not inherently fraudulent, even when unfriendly, Congress can rely on the substance of the laws already on the books to deal with cheaters.

Two, as to my second point, we oppose two-tier treatment of shareholders, whereby one group gets bonuses, premiums, or higher prices for their share in negotiated transactions, while other shareholders are reduced to the status of second-class corporate citizens.

Thus, by definition, we oppose greenmail, whereby management pays a corporate raider to go away, using our assets and diluting the value of our holdings. Under our penchant for equal treatment, whatever price is to be paid to the raider should also be offered all other shareholders.

We also oppose a variant defense, the poison pill, that makes it highly unprofitable for an outsider to seek corporate control. Control is an asset that belongs to shareholders; they should be free, in their discretion, to sell it or not. In the long run, the only beneficiaries of poison pills are entrenched managements whose positions are permanently secured by pills.

Three, as a corollary to our opposition to two-tier treatment overall, we specifically oppose the creation of different classes of common stock with varying voting rights.

That is the ultimate antitakeover defense, the ultimate poison pill for which no outsider will have an antidote.

The inevitable result of two classes of common stock is to concentrate the higher voting strength stock in the hands of shareholders friendly to existing managements. This concentration of a corporation's power effectively gives management a perpetual lease on the executive suite, making it inherently unaccountable to the real owners of the firm.

I question, therefore, the wisdom of the proposed rule change of the New York Stock Exchange to allow trading in the stock of companies that have different classes of common stock with radically varying voting strength.

Requiring that the voting differential between two classes of common stock be no greater than 10 to 1, even with the approval of two-thirds of the shareholders of a corporation, mocks the basic precepts of corporate democracy. Essentially, I need hold only 5 percent of a corporation's shares, of the kind that is superior by a ratio of 10 to 1, to control 50 percent of the company's outstanding votes. This proposal has all the earmarks of economic fascism. It should be rejected.

And to forestall the risk that some companies will abandon the New York Stock Exchange in headlong pursuit of the insulation from oversight and accountability for shareholders that is implicit in this change, the SEC should consider invoking its regulatory authority to protect shareholder rights by requiring uniform voting

rights for all classes of common stock that trade on any exchange or in the over-the-counter market.

I am certain that the SEC will, after due consideration, agree with my contention that shareholder rights are threatened by the proposed change. The SEC needs no additional legislative sanction to act on this matter.

In sum, I do not see the need for substantive legislative changes at this time. With the growing involvement of institutional investors, representing their beneficiaries and the identical interests of millions of individual shareholders, the marketplace should be given the chance to sort these matters out for itself.

[The complete prepared statement follows:]

TESTIMONY BY
COMPTROLLER HARRISON J. GOLDIN
U.S. SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS COMMITTEE
SUBCOMMITTEE ON SECURITIES
PUBLIC HEARING ON CORPORATE TAKEOVERS
DIRKSEN SENATE OFFICE BUILDING, ROOM SD-538
WASHINGTON, D.C.
THURSDAY, JUNE 6, 1985, 9:00 A.M.

I appreciate the opportunity to help further the national debate on how our society should respond to the seeming epidemic of hostile corporate takeover attempts and defensive reactions by management.

My special interest in the subject derives from my duty to preserve and enhance the value of billions of dollars worth of assets that are entrusted to my fiduciary care. As the elected Comptroller of the City of New York I am the custodian and/or asset manager of five actuarial pension systems, with more than 400,000 members and aggregate assets exceeding $23 billion, a sum expected to exceed $50 billion within the decade. At present, $7.8 billion, or 33.8%, of total current assets is invested in equities, the common stock of more than 1,200 American corporations.

That is a heavy commitment, giving us a large stake in the business health of the country, making us a significant owner of corporate America, with a keen interest in the long-term well-being of the firms we partly own. And of course, we have a profound interest in various mergers and attempted acquisitions,

unfriendly and otherwise, and their real and potential impact on the value of our assets.

While I speak today for the pension funds under my jurisdiction, I am also one of three co-chairmen of the recently formed Council of Institutional Investors. The Council comprises 22 pension funds across the country, with combined assets exceeding $100 billion. That represents 25% of the asset value of all public pension funds in America and nearly 7% of the $1.5 trillion estimated aggregate of all institutional portfolios, both public and private.

The Council is principally a vehicle for the exchange of information. As fiduciaries, its members do not and cannot delegate their trusteeship. But on matters in which we all have a stake, it is helpful to us to be able to exchange and receive information that will enable us better to make independent decisions in given corporate finance situations.

The Council was established in late January as a direct response to both real and potential asset value losses arising from certain defensive actions by managements to thwart attempted hostile corporate takeovers. These include greenmail, golden parachutes, poison pills, the issuance of new stock to insiders to dilute outstanding shares, creation of two classes of common stock with differing voting strengths, indeed, any action designed to frustrate acquisition of control or more by outsiders

and to entrench existing management permanently, thus making them virtually unaccountable to the shareholders, the real owners of the companies involved.

What has been the Council's response? By and large the members agree on at least three guiding standards that I, as New York City Comptroller, endorse, too:

1) Corporate takeovers are neither good nor bad in themselves;

2) The presumption is that two-tier treatment of shareholders is damaging to our beneficiaries; and

3) The creation of two classes of common stock with varying voting strengths is damaging to our beneficiaries and bad for the American economy.

Let me elaborate a bit on each of these points:

1) Mergers and acquisitions -- corporate takeovers, if you like -- are neither good nor bad in themselves. They must be considered on a case by case basis, with each asset manager determining what is best for his or her beneficiaries.

Some takeovers are bad: they do not offer the prospect of maximization of a company's assets through orderly long-term growth. But some are good: they fulfill given investment objectives and narrow the disparity between a company's asset value and the market price of its stock. So there is no ethical

imperative to legislate takeovers out of existence or necessarily restrict their frequency or scope.

When a so-called "corporate raider" makes a tender offer and management reacts defensively, it is up to each shareholder and potential investor, collectively comprising the "market place," to determine whether the raid or the defense will maximize their interest. We believe that that judgment is invariably far sounder than one made by Big Brother or any other institutional substitute.

Accordingly, the answer to the question of how society should respond to the takeover phenomenon is to ask rhetorically: Whose company is it anyway? It is surely not management's; nor is it government's. The company belongs to its owners, the shareholders.

It is, therefore, the shareholders' prerogative to make basic policy decisions about the direction of a corporation and its disposition: whether it should or should not be sold; whether it should be taken over or not; whether its management should be retained or replaced.

Shareholders, like anyone else, may make mistakes, and if they do, they will get their just desserts; but when their decisions are sound, they will be rewarded in the time-honored coin of capitalism, profit.

Clearly, legislation to restrict mergers and acquisitions

would simply substitute the judgment of government for the judgment of shareholders as collective owners of companies. And that would frustrate the free market.

Further, legislation restricting mergers and acquisitions would, paradoxically, ultimately not protect shareholders, either; essentially, it would restrict their opportunity to maximize the value of their investments. I want that opportunity for the pension systems I manage and not to have it restricted by statute or replaced by the discretion of government bureaucrats.

I do not want to be misunderstood. I and institutional investors like me are not short-term traders, looking for quick windfalls. We are not speculators. We do not ipso facto side with corporate raiders against managements.

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But we want to retain for ourselves as shareholders

discretion to make fundamental decisions about our investments. We want the opportunity to determine for ourselves whether an unfriendly takeover attempt is good or bad for our beneficiaries. We do not want that opportunity taken away from us by either government, through legislation, or the veil of the so-called "business judgment" of the managements of firms in which we own stock. Those managements should be obliged to secure our consent before erecting barriers calculated to frustrate reasonable offers, whether invited or not, for all or part of our stock.

Government's role should essentially be to prosecute fraud. And since mergers and acquisitions are not inherently fraudulent, even when unfriendly, Congress can rely on the substance of the laws already on the books to deal with cheaters.

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Thus, by definition, we oppose greenmail, whereby management pays a corporate raider to go away, using our assets and diluting the value of our holdings. Under our penchant for equal treatment, whatever price is to be paid to the raider should also be offered all other shareholders.

We also oppose a variant defense, the poison pill, that makes

it highly unprofitable for an outsider to seek corporate control. Control is an asset that belongs to shareholders; they should be free, in their discretion, to sell it or not. In the long run, the only beneficiaries of poison pills are entrenched managements whose positions are permanently secured by pills.

3) As a corollary to our opposition to two tier treatment overall, we specifically oppose the creation of different classes of common stock with varying voting rights.

That is the ultimate anti-takeover defense, the ultimate poison pill for which no outsider will have an antidote.

The inevitable result of two classes of common stock is to concentrate the higher voting strength stock in the hands of shareholders friendly to existing managements. This concentration of a corporation's power effectively gives management a perpetual lease on the executive suite, making it inherently unaccountable to the real owners of the firm.

I question, therefore, the wisdom of the proposed rule change of the New York Stock Exchange to allow trading in the stock of companies that have different classes of common stock with radically varying voting strength.

Requiring that the voting differential between two classes of common stock be no greater than 10 to 1, even with the approval of two-thirds of the shareholders of a corporation, mocks the basic precepts of corporate democracy. Essentially, I need hold

only 5% of a corporation's shares, of the kind that is superior by a ratio of 10 to 1, to control 50% of the company's outstanding votes. This proposal has all the earmarks of economic fascism. It should be rejected.

And to forestall the risk that some companies will abandon the New York Stock Exchange in headlong pursuit of the insulation from oversight and accountability for shareholders that is implicit in this change, the SEC should consider invoking its regulatory authority to protect shareholder rights by requiring uniform voting rights for all classes of common stock that trade on any exchange or in the market. I am certain that the SEC will, after due consideration, agree with my contention that shareholder rights are threatened by the proposed change. The SEC needs no additional legislative sanction to act on this matter.

In sum, I do not see the need for substantive legislative changes at this time. With the growing involvement of institutional investors, representing their beneficiaries and the identical interests of millions of individual shareholders, the marketplace should be given the chance to sort these matters out for itself.

Senator D'AMATO. Mr. Goldin, let me suggest that this has been a very, very fine presentation--not to say that your other presentations have not had equal merit. But you have a number of issues here that I think we can say that we all agree on. I'm very appreciative of your testimony here today.

Mickey.

STATEMENT OF MURIEL F. SIEBERT, CHAIRMAN, MURIEL SIEBERT & CO.

Ms. SIEBERT. Senators, I want to thank you for giving me this opportunity to participate in these proceedings.

To introduce myself, I had been on Wall Street for 30 years, having begun my career as a research trainee in late 1954. I founded Muriel Siebert & Co. in 1967, when I made the New York Stock Exchange coed. We are members of the New York Stock Exchange. We are discount brokers. Approximately 80 percent of our business is done with individual investors.

It is a paradox that while the stock market closed at historic highs yesterday, with a volume of almost 150 million shares, the individual investor is not active in today's market. I can't recall a similar such instance. And so the question is why are we seeing such a contradiction in today's securities markets?

PUBLIC BELIEVES THE MARKET IS FOR THE BIG BOYS

In my opinion, the public believes the market is strictly for the big boys and the little individual investor does not feel that he has been treated fairly. In fact, the individual has gotten seriously burned by investing in stocks that have appreciated in value and then plummeted after the raiders have moved in and were bought out by management to keep the peace.

In other cases, the individual has sold his holdings in a company, only to see the shares jump in price after a takeover attempt is rumored or a privately negotiated deal is announced.

The vast majority of those who get whipsawed in the market gyrations caused by the raiders and the defensive tactics of the target companies are the individual shareholders with small holdings—the same investor who has helped advance our economy through share ownership, owning a piece of America.

I have considerably more knowledge than the vast majority of individual investors; yet, I found myself boxed in on two investments through the actions of both a takeover artist and management actions to protect their own jobs.

A few years ago, I purchased 11,000 shares of Simplicity Pattern because it was selling near its cash value. Two or three raiders became interested in the company because of its huge cash reserves, most of which was invested in U.S. Treasury securities. Baywater Realty, controlled by Carl Icahn, had accumulated a large block of stock. It then made a tender offer for additional shares of Simplicity, but backed off when Simplicity's management bought his block of stock at a price that was higher than the marketplace and the book value in a private transaction.

No other public stockholders were offered the same price. While this maneuver ended the takeover attempt and made Mr. Icahn

money, it diluted the value of my holdings and those of other shareholders.

I exchanged nasty letters with management, but got nowhere. For the first time in my life, I attended an annual meeting for the purpose of putting management on the spot. Management had indeed prevented an unfriendly takeover, but in the process, rewarded itself with substantial raises, stock options, and golden parachute contracts. It decreased the value of my shares and those of other shareholders further.

Eventually, I sold my shares at a loss because I realized it was futile as the intrinsic value of the shares had decreased because of management's actions.

The other example—I am an investor in Emery Air Freight. After a period of disappointing earnings, the stock was depressed. The stock rose because of a rumor of a takeover. Fearful of a hostile takeover, the company decided to stagger the election of its board of directors so that one-third are appointed annually. This makes an unfriendly takeover difficult, if not really impossible. In addition, management took other antitakeover steps, referred to as poison pills, so that a takeover becomes quite unlikely.

Here, again, these moves, wise or not, fair or not, were done at the expense of other stockholders. Under these circumstances, a legitimate takeover is unlikely, even though it might be beneficial to all shareholders.

Actions such as these where management perpetuates itself, under the guise of doing what is best for the company and shareholders, are also taking away a basic right of shareholders—to have the opportunity to sell out if a fair offer is made for the company.

I use these experiences from my own investment history not to display stupidity publicly, but to point out that sophisticated investors are caught in the web of the battle between raiders and managements. Think of the individual investor and the inequity that this has thrust on him.

On another front, we have seen a tremendous increase in junk bonds to finance takeovers. Junk bonds—a poor quality debt instrument, as used by the raiders, present a real and serious danger. They are changing our cash-rich companies into debt-ridden entities.

The quality of many of these debt instruments should not entitle them to be called bonds and the public is not aware of just how risky these junk bonds are. Individual investors generally do not realize that the issuing companies may not be able to pay the interest on these junk bonds under certain circumstances. If the company's earnings were to decline appreciably, or there are bank borrowings tied to prime rate and the rates go back to 20 percent again, there may be no earnings or cash to pay the interest.

Clearly, as with most of any new offering, issuers of these bonds should be required to disclose on a pro forma basis what the impact would have been on the company's finances over a period of years, or even to present what would have occurred if these bonds had been issued, say, 5 to 10 years ago.

A good example of what is taking place in takeover financing is presented in the current Forbes magazine story describing how the

balance sheets of American companies are getting weaker by the minute. Forbes quotes Peter Carnellos, a tax partner at the New York Wachtell, Lipton, Rosen, Katz law firm, as estimating that one of Carl Icahn's offers for Phillips Petroleum would have raised the company's debt/equity ratio to 14:1 from about 1:1, and would save some $600 million a year in taxes.

DEBT/EQUITY RATIO COULD SPELL DISASTER

More importantly, a 14:1 debt/equity ratio could spell disaster for a company even as healthy as Phillips and, in the process, the bonds which stockholders had acquired for their shares could become almost worthless. Investors who swapped undervalued equity in corporations have had underutilized assets. They exchange assets for bonds in anticipation of receiving higher income. Instead they could find their income was reduced or eliminated under certain economic circumstances.

Perhaps equally disturbing is the fact that many companies whose balance sheets were relatively healthy are taking on substantially higher debt to buy shares and ward off takeovers and thereby putting their balance sheet and indeed the entire company at risk.

In my opinion, junk bonds should carry the statement, "Warning—this bond could be dangerous to your financial health."

Senator D'AMATO. Mickey, let me ask you something. Might that be characterized as an overstatement?

Ms. SIEBERT. No; I think that, in some cases, if you go through a recession and you take the earnings of the corporation, reduce the earnings where you have extreme leverage, you may not be able to pay interest. We have seen some of the corporations of the sixties and the seventies that have gone into chapter 11 because of debt.

Senator D'AMATO. Do you have any examples of the kind of situation that you state where those bonds have been used and where they are so highly speculative that they should be labeled in that manner? And what about the free market system where people must make choices and determinations with respect to the use of these bonds as to whether or not it would be appropriate to undertake an offer made? If you indeed had some bond that had little, if any, intrinsic value behind it?

Ms. SIEBERT. Well, if you take a company like Phillips and you put a 14:1 debt/equity ratio on it, and because of either the price of oil dropping or a decrease of demand, you will wipe out the equity. You may not earn as much money, especially if the company has bank loans tied to prime and they pay the bank loans before they pay the interest on the bonds.

Senator D'AMATO. Are you suggesting then that those bonds that you have determined junk bonds as we know don't have a rating, that they not be permitted to be utilized in corporate takeovers?

Ms. SIEBERT. No; I'm saying I don't think there has been a fair disclosure. I don't think the investing public understands the risk involved. In many cases, they feel that they are trading the common stock that is maybe paying 4 or 5 percent interest on their money for an investment that is paying them 13 or 14 percent, and,

believe, they will almost tripled their income. This income does not have the same stability.

Senator D'AMATO. How would you feel about that realistically? Are you saying that your proposal for disclosure would be the manner by which you would deal with that?

Ms. SIEBERT. Yes; I think the disclosure should be done, and it should be done in a way that perhaps goes back to the last recession, on a pro forma basis. I am not saying that we should regulate against the issuance of them but I believe the public does not understand the quality of the paper that they are receiving.

Senator D'AMATO. Doesn't corporate management have the opportunity to make that known? If you were suggesting, for example, to extend the time in which the stockholders has an opportunity to respond, it would seem to me that that would be appropriate, so that they could then let their shareholders know what the value of the offer is.

Ms. SIEBERT. Well, in many cases, I believe the corporations are not acting in a fair manner.

Senator D'AMATO. Which corporation? Chartered or the——

Ms. SIEBERT. The target companies in some cases are entering into deals where they're even offering to buy their own equity securities just to protect their own jobs. In some cases the securities they issue may be classified in my opinion as junk bonds.

Senator D'AMATO. Wouldn't Comptroller Goldin, for example, represent his shareholders in the Pension Fund, and those in similar positions with him, don't you think they would have the ability to ascertain before they respond to a takeover, whether or not the junk bonds, for example, were such a poor quality that they would then make a determination?

Ms. SIEBERT. Well, Mr. Goldin has professional managers managing the money. The individual stockholders do not. That's the difference.

Senator D'AMATO. Well, again, I would just simply suggest that I think at times there is an overreaction. Take some of the abuses that may exist. In other words, the two-tier offer, whether it's a period of time which is not sufficient—by the way, on the first panel you heard two people who have a different perspective entirely, Mr. Rohatyn and Mr. Joseph. And yet they agreed in many more areas than one might initially think in terms of the various safeguards that can and should be utilized, whether it be the thrift industry vis-a-vis the junk bonds and their utilization, whether it be in the two-tier offer, whether it be with respect to extending the period of time by which shareholders can make a decision, whether it be in the area of 13(d) where you may be closing that window.

I don't know how many of my colleagues believe that there would have been that kind of basic agreement, but what I am suggesting is that for us to rush into the gap in such a way as to keep the market forces—the legitimate market forces from reacting, would indeed positively penalize the very shareholders that you are concerned about.

And I think both of them also agreed, as did Comptroller Goldin, as you did in your prepared testimony, that there needs to be protection for the individual shareholder who, as a result of management's zest to protect its own position, may find itself with limited

voting rights, and I think the comptroller quite pointedly put forth the fact, although he might own 5 percent of the stock in a particular company, that he could or someone with 5 percent could leverage it out up to 50 percent and thereby significantly control or would control the corporate governance as opposed to the balance of the shareholders.

So I think there's a great agreement. I just suggest that sometimes, by saying that the junk bonds—and I wonder about the terminology—but the high yield the bonds are assigned in such a manner would not in the long run be a disservice to the capital formation in this country.

Ms. SIEBERT. I question the knowledge that the individual investor has. I also question, because there are many institutions—Harrison Goldin has the advantage of the luxury of long-term investments. The mutual funds that are open ended receive their money based on the performance of those funds. They must go after short-term performance or they do not sell additional shares.

So you have a lot of institutional investors that will take a profit and run. They are not looking at the long-term economic health of the corporations of this country.

Senator D'AMATO. I'm going to at this time ask that the balance of your remarks be included in the record as if read in their entirety.

[The complete prepared statement follows:]

"THE DISENFRANCHISED INDIVIDUAL INVESTOR"

MURIEL SIEBERT, PRESIDENT

MURIEL SIEBERT & CO., INC.
MEMBER, NEW YORK STOCK EXCHANGE

FORMER - SUPERINTENDENT OF BANKS FOR NEW YORK STATE

SENATORS, I THANK YOU FOR GIVING ME THIS OPPORTUNITY TO PARTICIPATE IN THESE PROCEEDINGS.

CERTAINLY, THE FACT THAT THIS AUGUST BODY IS GATHERED TO CONSIDER THE IMPLICATIONS OF THE FLOOD TIDE OF TAKEOVERS BY SO-CALLED CORPORATE RAIDERS IS EVIDENCE IN ITSELF THAT THE PRACTICE IS REACHING CRISIS PROPORTIONS.

TO INTRODUCE MYSELF, I HAVE BEEN ON WALL STREET FOR OVER 30 YEARS, HAVING BEGUN MY CAREER AS A RESEARCH TRAINEE IN 1954. I FOUNDED MURIEL SIEBERT & CO. IN 1967 WHEN I MADE THE STOCK EXCHANGE CO-ED. WE ARE MEMBERS OF THE NEW YORK STOCK EXCHANGE. WE ARE DISCOUNT BROKERS. APPROXIMATELY EIGHTY PERCENT OF OUR BUSINESS IS DONE WITH INDIVIDUAL INVESTORS.

IT'S A PARADOX THAT WHILE THE STOCK MARKET HAS REACHED HISTORIC HIGHS IN RECENT MONTHS, THE INDIVIDUAL INVESTOR IS NOT ACTIVE. I CAN'T RECALL A SIMILAR SUCH INSTANCE AND SO THE QUESTION IS WHY ARE WE SEEING SUCH A CONTRADICTION IN TODAY'S SECURITIES MARKETS.

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I SEE THE ANSWER VERY PURELY AND SIMPLY THAT THE PUBLIC BELIEVES THE MARKET IS STRICTLY FOR THE BIG BOYS AND THE LITTLE - THE INDIVIDUAL INVESTOR - DOES NOT FEEL HE HAS BEEN TREATED FAIRLY.

IN FACT, THE INDIVIDUAL HAS GOTTEN SERIOUSLY BURNED BY INVESTING IN STOCKS THAT HAVE APPRECIATED IN VALUE AND THEN PLUMMETED AFTER THE RAIDERS HAVE MOVED IN AND WERE BOUGHT OUT BY MANAGEMENT TO KEEP THE PEACE. OR, THE INDIVIDUAL HAS SOLD HIS HOLDINGS IN A COMPANY ONLY TO SEE THE SHARES JUMP IN PRICE AFTER A TAKEOVER ATTEMPT IS RUMORED OR A PRIVATELY NEGOTIATED DEAL IS ANNOUNCED. THE VAST MAJORITY OF THOSE WHO GET WHIPSAWED IN THE MARKET GYRATIONS CAUSED BY THE RAIDERS, AND THE DEFENSIVE TACTICS OF THE TARGET COMPANIES, ARE THE INDIVIDUAL SHAREHOLDERS WITH SMALL HOLDINGS - THE SAME INVESTOR WHO HAS HELPED ADVANCE OUR ECONOMY THROUGH SHARE OWNERSHIP - "OWNING A PIECE OF AMERICA."

WITH MY 30 YEARS IN THE INVESTMENT FIELD, I HAVE CONSIDERABLY MORE KNOWLEDGE THAN THE VAST MAJORITY OF INDIVIDUAL INVESTORS, YET I FOUND MYSELF BOXED IN ON TWO INVESTMENTS THROUGH THE ACTIONS OF BOTH A TAKEOVER ARTIST AND MANAGEMENT ACTIONS TO PROTECT THEIR OWN JOBS.

I PURCHASED 11,000 SHARES OF SIMPLICITY PATTERN, BECAUSE IT WAS SELLING NEAR ITS CASH VALUE. TWO OR THREE RAIDERS BECAME INTERESTED IN THE COMPANY BECAUSE OF ITS HUGE CASH RESERVES, MOST OF WHICH WAS INVESTED IN U.S. TREASURY SECURITIES. BAYWATER REALTY, CONTROLLED BY CARL ICAHN, HAD ACCUMULATED A LARGE BLOCK OF STOCK. IT THEN MADE A TENDER OFFER FOR SIMPLICITY, BUT BACKED OFF WHEN SIMPLICITY'S MANAGEMENT BOUGHT HIS BLOCK OF STOCK AT A PRICE HIGHER THAN THE MARKET PRICE AND BOOK VALUE.

WHILE THIS MANEUEVER ENDED THE TAKEOVER ATTEMPT BY MR. ICAHN AND MADE HIM SAVE MONEY, IT DILUTED THE VALUE OF MY HOLDINGS AND THOSE OF OTHER SHAREHOLDERS.

I EXCHANGED LETTERS WITH MANAGEMENT, BUT GO NO WHERE. FOR THE FIRST TIME IN MY LIFE, I ATTENDED AN ANNUAL MEETING FOR THE PURPOSE OF PUTTING MANAGEMENT ON THE SPOT. MANAGEMENT HAD INDEED PREVENTED AN UNFRIENDLY TAKEOVER, BUT IN THE PROCESS REWARDED ITSELF WITH SUBSTANTIAL RAISES, STOCK OPTIONS AND GOLDEN PARACHUTE CONTRACTS, BUT IN THE PROCESS DECREASED THE VALUE OF MY SHARES AND THOSE OF OTHER SHAREHOLDERS.

EVENTUALLY I SOLD MY SIMPLICITY SHARES AT A LOSS BECAUSE I REALIZED IT WAS FUTILE AS THE INTRINSIC VALUE OF THE SHARES HAD DECREASED BECAUSE OF MANAGEMENT'S ACTIONS.

I AM AN INVESTOR IN EMERY AIR FREIGHT. I BOUGHT 15,000 SHARES BECAUSE I HAD FAITH IN THE COMPANY'S FUTURE, AND THE POTENTIALS OF THE INDUSTRY.

AFTER A PERIOD OF SEVERAL YEARS OF DISAPPOINTING EARNINGS, THE STOCK WAS DEPRESSED. FEARFUL OF A HOSTILE TAKEOVER, THE COMPANY DECIDED TO STAGGER THE ELECTION OF ITS BOARD OF DIRECTORS SO THAT ONE-THIRD ARE APPOINTED ANNUALLY. THIS MAKES A TAKEOVER DIFFICULT. IN ADDITION, MANAGEMENT TOOK OTHER ANTI-TAKEOVER STEPS, REFERRED TO AS "POISON PILLS", SO THAT A TAKEOVER BECOMES UNLIKELY.

CONCOMMITANTLY, THEY ISSUED THEMSELVES "GOLDEN PARACHUTE" CONTRACTS.

HERE AGAIN THESE MOVES, WISE OR NOT, FAIR OR NOT, WERE DONE AT THE EXPENSE OF STOCKHOLDERS. UNDER THESE CIRCUMSTANCES, A TAKEOVER OFFER IS UNLIKELY EVEN THOUGH IT MIGHT BE BENEFICIAL TO ALL SHAREHOLDERS AND THE FUTURE OF THE CORPORATION.

ACTIONS SUCH AS THESE, WHERE MANAGEMENT PERPETUATES ITSELF UNDER THE GUISE OF DOING WHAT IS BEST FOR THE COMPANY AND SHAREHOLDERS, ARE ALSO TAKING AWAY A BASIC RIGHT OF SHAREHOLDERS -- TO HAVE THE OPPORTUNITY TO SELL OUT IF A FAIR OFFER IS MADE FOR THE COMPANY.

I USE THESE EXPERIENCES FROM MY OWN INVESTMENT HISTORY TO POINT OUT THAT EVEN THOSE OF US WHO ARE CONSIDERED SOPHISTICATED INVESTORS ARE CAUGHT IN THE WEB OF THE RAIDERS AND MANAGEMENTS THAT MAY BE OUT TO PROTECT THEIR OWN JOBS, OR EGOS.

ON ANOTHER FRONT, WE HAVE SEEN A TREMENDOUS INCREASE IN JUNK BONDS TO FINANCE TAKEOVERS.

JUNK BONDS (A POOR QUALITY DEBT INSTRUMENT), AS USED BY THE RAIDERS, PRESENT A REAL AND SERIOUS DANGER. THEY ARE CHANGING OUR CASH RICH COMPANIES AND, IN SOME CASES, INDUSTRIES INTO DEBT RIDDEN ENTITIES.

THE QUALITY OF MANY OF THESE DEBT INSTRUMENTS SHOULD NOT ENTITLE THEM TO BE CALLED "BONDS". AND, THE PUBLIC IS NOT AWARE OF JUST HOW RISKY THESE JUNK BONDS ARE. INDIVIDUAL INVESTORS GENERALLY DO NOT REALIZE THAT THE ISSUING COMPANIES MAY NOT BE ABLE TO PAY THE INTEREST ON THESE JUNK BONDS UNDER CERTAIN CIRCUMSTANCES. IF THE COMPANY'S EARNINGS WERE TO DECLINE APPRECIABLY, OR THERE ARE BANK BORROWINGS TIED TO PRIME RATE AND RATES GO BACK UP THERE MAY BE NO EARNINGS IN CASH THEN TO PAY THE INTEREST.

CLEARLY, AS WITH MOST ANY NEW OFFERING, ISSUERS OF THESE BONDS SHOULD BE REQUIRED TO DISCLOSE ON A PROFORMA BASIS WHAT THE IMPACT WOULD BE ON THE COMPANY'S FINANCES OVER A PERIOD OF YEARS, OR EVEN TO PRESENT WHAT WOULD HAVE OCCURRED IF THE BONDS HAD BEEN ISSUED, SAY FIVE TO TEN YEARS AGO. THIS REQUIREMENT WOULD GIVE ALL SHAREHOLDERS THE INFORMATION NECESSARY TO MAKE A MORE QUALIFIED JUDGMENT AS TO WHETHER THEY SHOULD HOLD THEIR SHARES, OR EXCHANGE THEM FOR THE JUNK BONDS BEING OFFERED BY THE RAIDER OR THE CORPORATION TO PREVENT A RAID.

A GOOD EXAMPLE OF WHAT IS TAKING PLACE IN TAKEOVER FINANCING IS PRESENTED IN A CURRENT FORBES MAGAZINE STORY DESCRIBING HOW THE BALANCE SHEETS OF AMERICAN COMPANIES ARE GETTING WEAKER BY THE MINUTE.

FORBES QUOTES PETER CARNELLOS, A TAX PARTNER AT NEW YORK'S WACHTELL, LIPTON ROSEN & KATZ, AS ESTIMATING THAT ONE OF CARL ICAHN'S OFFERS FOR PHILLIPS PETROLEUM WOULD HAVE RAISED THE COMPANY'S DEBT/EQUITY RATIO TO FOURTEEN TO ONE FROM ABOUT ONE-TO-ONE AND SAVED SOME $600 MILLION A YEAR IN TAXES. MR. ICAHN WAS COUNTING ON THE U.S. TAXPAYER TO HELP PAY FOR HIS RAID.

THIS IN ITSELF IS TOTALLY UNFAIR WHEN WE ARE CURRENTLY FACING A NEED TO GENERATE ALL THE TAXES WE CAN TO PAY THE BURDENSOME NATIONAL DEBT. BUT MORE IMPORTANT IS THAT THE FOURTEEN-TO-ONE DEBT IS STAGGERING, AND COULD SPELL UTTER DISASTER FOR A COMPANY EVEN AS HEALTHY AS PHILLIPS PETROLEUM AND IN THE PROCESS WIPE OUT THE ENTIRE VALUE OF THE BONDS WHICH STOCKHOLDERS HAD ACQUIRED FOR THEIR SHARES. PERHAPS EQUALLY DISTURBING IS THAT MANY COMPANIES WHOSE BALANCE SHEETS WERE RELATIVELY HEALTHY ARE TAKING ON SUBSTANTIALLY HIGHER DEBT TO WARD OFF TAKEOVERS AND ARE THEREBY PUTTING THEIR BALANCE SHEET - AND INDEED THE ENTIRE COMPANY - AT RISK.

ONCE AGAIN I WOULD LIKE TO STRESS, TAKEOVER ARTISTS SHOULD BE REQUIRED TO MAKE FULL DISCLOSURES ON THE DEBT WITH WHICH THEY ARE SADDLING THE QUARRY COMPANY. AND I UNDERSCORE FULL DISCLOSURE. IT SHOULD REVEAL WHAT COULD HAPPEN TO THE TARGET COMPANY UNDER CERTAIN CIRCUMSTANCES, SUCH AS HIGHER INTEREST RATES OR WHEN A COMPANY'S EARNINGS FALL TO THE LEVEL WHERE IT HAS DIFFICULTY PAYING ITS DEBT.

OTHERWISE, JUNK BONDS SHOULD CARRY THE STATEMENT "WARNING -- THIS BOND COULD BE DANGEROUS TO YOUR FINANCIAL HEALTH."

HISTORY SHOWS THAT SOME OF THE CORPORATIONS THAT GOBBLED UP OTHER FIRMS DURING THE MERGER MANIA OF THE 1960's RAN INTO TROUBLE IN THE LATE 1970's AND 1980's BECAUSE OF THE HIGHER DEBT THEY TOOK ON. SOME OF THE COMPANIES HAVE HAD TO FILE FOR PROTECTION UNDER CHAPTER 11, WHILE OTHERS HAVE HAD TO UNDERGO SEVERAL REFINANCINGS TO AVOID TOTAL DISASTER.

THESE EVENTS, AND THE ACTIONS OF TODAY'S RAIDERS, SHOULD MAKE IT ABUNDANTLY CLEAR THAT WE ARE ON A DANGEROUS COURSE. AND, IF WE FOLLOW THE COURSE UNCHECKED, WE WILL SEVERELY DAMAGE THE VERY FABRIC OF OUR NATION'S ECONOMIC SYSTEM.

CLEARLY, THE TIME TO TAKE ACTION, TO PREVENT EVEN MORE SUCH TRAVESTY, IS NOW. THE SOLUTION IS SIMPLE - FIRST, GIVE THE SEC STANDBY, TEMPORARY AUTHORITY TO STOP THE GAME, WHILE THE REGULATORY AND LEGISLATIVE AUTHORITIES GRIND OUT NEW RULES.

THE URGENCY FROM THE POINT OF VIEW OF THE SMALLER INVESTOR, THE "LITTLE GUY", IS IMMEDIATE.

AS DEVASTATING AS THE FINANCIAL RAMIFICATIONS MAY BE TO THE UNSUSPECTING SMALLER INVESTOR, OF EQUAL IMPORTANCE TO THE ECONOMIC FABRIC OF OUR SOCIETY IS THE EROSION OF

CONFIDENCE IN THE FAIRNESS OF THE SECURITIES BUSINESS THAT THESE TAKEOVER OR GREENMAIL AFFAIRS ARE HAVING, AND THE FAR WIDER CONSEQUENCES WHICH VERY WELL MAY DEVELOP. THE SEC WAS CREATED BY CONGRESS WITH THE GOAL THAT ALL SHAREHOLDERS ARE EQUAL. IN TODAY'S TAKEOVER MARKETPLACE THIS SIMPLY IS NOT SO.

ALL OF US INVOLVED IN THE INVESTMENT BUSINESS - AND SERIOUSLY CONCERNED WITH ITS FUTURE - HAVE SPENT YEARS TRYING TO BUILD PUBLIC CONFIDENCE IN OUR INSTITUTIONS - AND PRACTICES.

NOT TOO MANY YEARS AGO, WHEN SOME WALL STREET FIRMS WERE IN SERIOUS FINANCIAL STRAITS, WE, THE MEMBERS OF THE NEW YORK STOCK EXCHANGE, CLOSED RANKS AND CONTRIBUTED A PORTION OF OUR COMMISSIONS FOR SEVERAL YEARS TO A FUND ORGANIZED FOR THE PURPOSE OF PROTECTING THE CUSTOMERS OF THE TROUBLED FIRMS. IT WAS THIS EFFORT THAT LED TO THE CREATION OF THE SECURITIES INVESTORS PROTECTION CORPORATION, DESIGNED TO INSTILL PUBLIC CONFIDENCE IN THE SECURITIES BUSINESS.

WE HAVE PREACHED - AND MOST PRACTICED - FAIRNESS IN THE MARKETPLACE.

AND, WE HAVE URGED THE PUBLIC AND OUR CLIENTS TO "INVESTIGATE - BEFORE YOU INVEST," IN ORDER TO BUILD IN THAT ADDED SAFETY FACTOR. THE GOVERNMENT CREATED IRA'S AND KEOGH'S TO HELP INDIVIDUALS PLAN FOR THEIR FUTURE, IN THE EXPECTATION THAT THESE INVESTMENTS WOULD ALSO PROVIDE A NEW SOURCE OF FUNDS FOR CORPORATIONS.

BUT, ALAS, WITH ONE BLOW, WE ARE SEEING THE INVESTMENT COMMUNITY SUFFERING NEW PUBLIC SKEPTICISM. AND, NO AMOUNT OF INVESTIGATING COULD, IN PRIVATELY NEGOTIATED DEALS, PREVENT THE SMALL INVESTOR FROM GETTING HURT. HE OR SHE CANNOT BE PRIVY TO PRIVATE DEAL-MAKING.

IT'S DEFINITELY TIME TO CALL A HALT TO THESE OUTRAGES VISITED BY CORPORATE AND INVESTOR INSIDERS ON THE INVESTING PUBLIC. GREENMAIL GAMBITS HAVE OUTFLANKED ALL THE RULES AND REGULATIONS WHICH WERE PROMULGATED TO ELIMINATE SIMILAR EARLIER EVILS. THERE SIMPLY IS NOT A MOMENT TO LOSE IN ENACTING NEW LEGISLATION THAT WILL CLOSE THE LOOPHOLES THAT HAVE ENABLED A SMALL HANDFUL OF SELF-SERVING, WELL-HEELED INVESTORS TO FORCE EVEN QUALITY, SUCCESSFUL COMPANIES TO TAKE MEASURES WHICH MAY BE DETREMENTAL TO THE COMPANY'S FUTURE GROWTH. IN SOME CASES COMPANIES ARE BORROWING TO RETIRE EQUITY THUS DEPRIVING THEMSELVES OF THE CASH NEEDED TO FINANCE GROWTH.

IN SUM, THERE IS SIMPLY NO VALID JUSTIFICATION FOR PERMITTING CONTINUANCE OF THIS PRACTICE.

I, THEREFORE, CALL FOR ACTION BY CONGRESS, THE SEC AND RESPONSIBLE CORPORATE MANAGERS TO ENACT LEGISLATION AND RULES THAT WILL MAINTAIN CORPORATE FLEXIBILITY AND THE FREE MARKETPLACE, BUT ELIMINATE SELF-SERVING TRANSACTIONS.

MY SPECIFIC RECOMMENDATIONS ARE:

FIRST, RECOGNIZING THAT LEGISLATION TAKES TIME, AND IN LIGHT OF THE URGENT NEED TO LOSE NOT TIME IN SHUTTING DOWN THE RAIDERS' TAKEOVER GAME, I URGE CONGRESS TO GIVE THE SEC THE NECESSARY STANDBY, TEMPORARY AUTHORITY TO DO SO.

SECOND, FULL DISCLOSURE ON THE PART OF THE RAIDER AND THE TARGET COMPANY SHOULD BE REQUIRED AFTER FIVE PERCENT OF THE TARGETED COMPANY STOCK HAS BEEN ACQUIRED. AND THE ACQUIRER SHOULD NOT BE ALLOWED TO BUY ADDITIONAL SHARES UNTIL OUTSIDE SHAREHOLDERS HAVE HAD A REASONABLE TIME TO EVALUATE THE DEVELOPMENTS.

THIRD, ALL SHAREHOLDERS SHOULD HAVE THE OPPORTUNITY TO SELL THEIR SHARES AT THE SAME PRICE AS IS OFFERED THE RAIDER.

FOURTH, DISCLOSURE OF THE PROFORMA IMPACT OF ADDED DEBT, EITHER BY THE RAIDER OR THE CORPORATION, MUST BE REQUIRED. THE EXTENT OF THESE BORROWINGS AND THIER IMPACT ON EARNINGS AND THE COMPANY'S FINANCAIAL CONDITION MUST BE DISCLOSED.

FIFTH, ELIMINATE "GOLDEN PARACHUTE" CONTRACTS WHICH ARE DESIGNED TO PERPETUATE EXECUTIVE TENURE.

SIXTH, ANY LEGITIMATE BID FOR CONTROL OF A COMPANY MUST BE DISCLOSED TO STOCKHOLDERS.

TO SUM UP, WE MUST RESTORE FAIRNESS AND EQUAL FINANCIAL OPPORTUNITY TO ALL INVESTORS, PARTICULARLY THE SMALLER INVESTOR WHO HAS BEEN EFFECTIVELY DISENFRANCHISED BY THE RECENT WAVE OF TAKEOVERS. STRONG ACTION MUST BE TAKEN SO THAT INTEGRITY IS RESTORED, AND A FREE MARKETPLACE EXISTS FOR INDIVIDUALS, INSTITUTIONS AND CORPORATIONS.

THANK YOU FOR THIS OPPORTUNITY TO PRESENT MY THOUGHTS.

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Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Ms. Siebert, you say in your recommendation on page 11, your first one—I presume one of the most important:

> * * * recognizing that legislation takes time and in light of the urgent need to lose no time in shutting down the raider takeover game, I urge Congress to give the SEC the necessary standby temporary authority to do so.

What makes you think the SEC will do anything about it? Chairman Shad of the SEC has testified before this committee. He seems to have pretty much of a laissez-faire attitude. He thinks takeovers are all right and the free market works.

Ms. SIEBERT. Well, I happen to believe in the free marketplace but I watch the tapes. When I'm in the office, I have a Dow Jones on my desk. And in many cases, I think the SEC would be encouraged to act because as the previous person said who testified, what happens now is they announce the 5-percent position but they have other blocks locked up.

So shortly after they announce 5 percent, it goes to 10, or 15, or 20 percent because they have had a negotiated deal for the blocks, which are then traded on markets other than the New York Stock Exchange, where the public sees them.

I think there are things that Chairman Shad would do if he were encouraged.

Senator PROXMIRE. Well, we'd better encourage him pretty quickly and give him a direct explicit order of some kind or you're not going to get much out of the SEC, according to the testimony he has given us. He's been before the committee at least twice on this issue and that's the reaction I get. And if we do that, of course, we might as well just pass legislation.

FREE MARKET IS WORKING WELL IN THE SHORT RUN

Now, Mr. Goldin, in your conclusion, you really don't see much of a problem here, at least nothing Congress could get involved in. You think the free market is working pretty well. In the short run, it is. I can see you sitting there with an enormous amount of money, billions of dollars in corporate equities and with a takeover game increasingly the values of those equities, I can understand that.

But it seems to me in the long run there are some other considerations. No. 1, is that some of these companies of course are getting heavily leveraged, in debt; they're more fragile, more vulnerable.

No. 2, there is certainly a tendency for management to be discouraged from engaging in the kind of research and development which is quintessential to the progress of our industry because that's a longrun payoff, and it usually doesn't give you an increase in the value of your stock until the research is proven and that's down the way a little bit.

So it seems to me that your view is kind of short term. What is your reaction?

Mr. GOLDIN. I don't think that's true, Senator. If the equities were as one sided as your recital might suggest, it would be true,

for example, that takeovers were only a disadvantage to the company.

Senator PROXMIRE. No, I don't say that.

Mr. GOLDIN. Well, if you will let me finish. If many takeover attempts did not provide a vehicle for which the disparity between market value and asset value can be narrowed, did not provide a mechanism for displacing ineffective corporate management, did not provide a vehicle for reallocating assets to the benefit of the whole economy, maybe you would be correct that because the equities were so one sided, that action legislatively, from a regulatory standpoint would be warranted.

The thrust of my comments and I think most of the others suggest however that, as I put earlier in my prepared remarks, the takeovers are not the subject of an ethical or moral imperative. Some are good and some are bad. They need to be evaluated individually. Therefore, I suggest that direct legislation limiting takeovers per se would be unwise.

I did not address myself in my prepared comments to other kinds of actions which might be appropriate to be taken from a regulatory standpoint, administrative or legislative, either by the Federal Government or by States that might limit abuses.

For example, some of them were referred to by the panel earlier this morning, requiring that somebody that makes an offer for a corporation be able to demonstrate the availability of cash either directly or through a takedown; requiring as many States do, debt/equity ratios as they apply to different kinds of corporations; limiting as many States do the investment activities of fiduciaries who tend to be the main purchasers of these kinds of securities. It seems to me that those are all appropriate actions.

But what I think is unwise is to try to legislate limitations on takeovers, hostile or friendly per se, for the reasons that I indicated.

Senator PROXMIRE. Mr. Goldin, you and I are both elected officials. Some people call us politicians. That has its advantages and disadvantages, but one is a sensitivity to the opinion of many groups in our society. In New York and Wisconsin, we are concerned about the attitude of the working people and their organizations, their unions.

The executive council of the AFL–CIO and other significant labor groups have condemned the surge in hostile takeovers. For example, the AFL–CIO position, and I quote, says:

> The economic health of the United States is threatened by an epidemic of corporate takeovers by raiders and leveraged buyouts.

They go on in some detail to say:

> America can ill-afford this waste of scarce resources and the losses being suffered now are only the beginning.

Do you see any merit in their view?

Mr. GOLDIN. I think the language is unduly alarmist.

Senator PROXMIRE. You say it's unduly alarmist. I take it that means you disagree with it.

Mr. GOLDIN. I have reservations about it, as I indicated in my prepared remarks. To the extent anybody would suggest that take-

overs, hostile or friendly, are damaging to the economy per se, I disagree.

Senator PROXMIRE. Well, earlier this morning, Mr. Rohatyn testified that takeover bids currently favor professional traders to the detriment of nonprofessionals.

Do you agree that that's the case and, if so, what, if anything, do you think we should do about that? You have a highly professional operation and I'm sure you are very skilled in the way you make your investments.

The typical investor, as Ms. Siebert made very clear, is pretty much out of the market or is less a participant in the market.

Mr. GOLDIN. I think it becomes increasingly difficult, Senator Proxmire, even for individual shareholders to argue that they don't appreciate the increase in risk inherent in some of these situations, given the enormous amount of publicity attendant upon them, given the dramatic yield involved in some of these situations. It comes with ill grace, it seems to me, for investors to say, as Ms. Siebert put it, that exchanging of a 4- or 5-percent yield security for a 15- or 16-percent yield security, the investors did not realize it was going to involve an increase in risk.

On the other hand, I do think it's appropriate that certain procedural changes be made—and a number of them have been suggested, such as the reporting period. There are procedural changes which I think would be appropriate. Even substantive changes that relate to the ability of corporations to structure themselves in certain ways, the requirement that certain kinds of matters be submitted for the approval of shareholders, for the kinds of institutions that would be able to make purchases and the degree to which.

But I emphasize again strongly I think it unwise, given the balanced equities between takeovers that are good and takeovers that are bad, the companies involved and for the economy overall, for the Congress to undertake to restrict the takeover activity directly.

Senator PROXMIRE. I just have one final question because I realize the time is short and we have two more panels coming up.

STEPS TO BRING SMALL INVESTORS BACK INTO THE MARKET

And Ms. Siebert, you made a very good case I thought, a very strong case for individual investors and the growing frustration among individual investors as large institutions take over the market, the everyday, individual investor is not being treated fairly. What steps do you think should be taken to bring the individual back into our markets and restore his or her confidence in our capital structure?

Ms. SIEBERT. I think the IRA's and the Keough's are a great step forward. Because some of that money will go into stocks and equities. They have been investing for the most part—it has been going into higher yielding bonds, zero coupons bank, and bank deposits. But as the yields come down on fixed income securities I believe that stocks and equities will be more attractive if the individual investor does indeed get a fairer shot.

Senator PROXMIRE. But you don't think they get a fair shot at the present time especially with the institutional domination and

with the takeover operations and with the insider information et cetera?

Ms. SIEBERT. I think the takeover has been just totally dominating the headlines of all of the financial pages and it has not been good. It's not encouraging.

Senator PROXMIRE. Thank you. Thank you, Mr. Chairman.

Senator D'AMATO. Senator Metzenbaum.

Senator METZENBAUM. Ms. Siebert, I appreciate your comments about the small shareholder and I think that you're right on target in your comments. I share with Senator Proxmire the concern about relying upon the SEC to take any action or because they haven't indicated anything but a laissez-faire approach up to this point and my guess is we will have as much difficulty giving them this authority as we would to enact the legislation itself.

But I do feel the thrust of your remarks are 100 percent in the right direction and I commend you for it.

Mr. Goldin, I would like to ask you, are you speaking on behalf of yourself or on behalf of the Council of Institutional Investors?

Mr. GOLDIN. As I indicated in my prepared remarks, Senator, I'm speaking on my own behalf although to the extent that I indicated in my prepared comments I am expressing the sense of the council on three fundamental propositions. I am reflecting the essential views of the council.

Senator METZENBAUM. I know your reputation and it's a good reputation and by your testimony it's obvious you are intelligent and by your very position you ought to be where you are. But from that point I stop. Stop. [Laughter.]

I am absolutely confounded by your testimony:

> Legislation to restrict mergers and acquisitions would simply substitute the judgment of Government for the judgment of shareholders as collective owners of companies and that would frustrate the free market.

Now, there probably have not been many Members of Congress who have spoken more loudly and more directly to this issue and proposed a legislative package that I have than I, and don't know anything that anybody's talked about as substituting the judgment of Government for the judgment of shareholders as the collective owners of companies.

Nobody talks about substituting Government judgment; nobody talks about—we talk about two-tier offers. That's not substituting the judgment of Government. We talk about 21-percent threshold as far as requiring a bid for all shares once the 21-percent threshold is reached. We propose extending the waiting period for tender offers to 60 days. That's not substituted judgment.

Finally, we would require target management to get shareholder approval for any structural change in the companies, such as issuing new stock.

None of that is a substituted judgment and in all fairness I want to say you then go on in your testimony further to make certain observations about things that are happening that you're not happy about, and I don't understand where you get this judgment of Government substitution.

Mr. GOLDIN. Well, let me respond to both points, Senator, and say that I reciprocate in admiration of your effectiveness and ability, so I hope you will accept my differing with you in that spirit.

Senator METZENBAUM. And I respect your right to be wrong. [Laughter.]

Mr. GOLDIN. And I respect your right to insist you are right when you're wrong. [Laughter.]

Senator METZENBAUM. I appreciate that.

Mr. GOLDIN. I would argue that although the rhetoric that I use to characterize the proposed regulatory scheme may be very direct and blunt, that some of the suggestions that you offer would have an effect opposite from what you want.

For example, control of a corporation, quite apart from ownership of a corporation, is an asset, and that asset belongs to the shareholders. And it seems to me that shareholders ought to have the ability without being restricted by legislation to decide that they want to sell the control of the corporation even while retaining interest in it.

It is for that reason that despite the English example I oppose a restriction that would in effect make it very difficult for shareholders to sell control because it would raise substantially the threshhold of an offer and therefore restrict offers for control.

As a consequence, I would adhere to my rhetoric in urging rejection of a proposal that when a threshhold--21 percent, 25 percent, any other percent—of an offer for shares has been made, that that would automatically trigger a requirement that the entire company be bought.

Senator METZENBAUM. No, I didn't say that.

ALL SHAREHOLDERS TREATED EQUALLY

Mr. GOLDIN. And that the shareholders—if I can be permitted to finish—as a shareholder I have no objection and I think it's equally protective of institutional shareholders and individual shareholders, as long as the requirement is that all shareholders be treated proportionately equal, that we be offered a price for part of our shares rather than for all shares.

Senator METZENBAUM. I understand that.

Now, how do we achieve that objective without legislation? How do we achieve the objective that you talk about that those managements should be obliged to secure our consent before wrecking various calculated to frustrated reasonable offers, whether invited or not for all or part of the stock? How do you achieve your position of opposing a two-tiered treatment of shareholders? Or how do we achieve your opposition to opposing greenmail and, you also oppose the poison pill. We are in agreement in that.

But my question is how do you reach those objectives without having legislation?

Mr. GOLDIN. Senator, you may have gotten the mistaken impression because I dealt fairly narrowly in my prepared remarks with the three essential substantive thrusts, that I am hostile to legislation where I consider it to be appropriate. In response to Senator Proxmire, I indicated areas where I think legislation is appropriate

both on the Federal and the State level and I enumerated some of them.

Let me remind you we now have extensive legislation in this country which limits the investment authority of fiduciaries, what kind of securities they can buy.

It seems to me that that is an area that needs to be reexamined in the context of the growth of high yield securities as vehicles not just for financing emerging companies but for financing mature companies. It seems to me it would be inappropriate first to require from a Federal standpoint that somebody who proposes to acquire more than a given percentage of a company be required to demonstrate the ability of cash, either directly or on a contingent basis.

It seems to me it is inappropriate that we limit for certain categories of companies in ways that are done to some extent already in State law, debt/equity ratios. So I'm not expressing hostility to legislative regulation or administration oversight. What I indicated is that on the subject of takeovers per se I think it would be unwise for the Congress to legislate directly prohibitions because they would necessarily give rise to a need to administratively distinguish between those which are good and those which are bad which I don't think can be done generically. I think it can be done only on an individual basis, on a case-by-case analysis.

Senator METZENBAUM. There is legislation pending now and there has been some special legislation on different points to bar specific takovers. You and I would be in total agreement on that. As I understand your testimony now—and I gather it's different than I had interpreted it—my understanding was that you were opposed to any kind of legislation. You're saying you're opposed to any legislation that is directed at a specific takeover, but that you are not opposed to legislation in the area, let's say, of greenmail or two-tier treatment, to that type.

Mr. GOLDIN. Senator, so I'm not misunderstood today, I do not want the Congress and I do want a Federal regulatory authority to begin distinguishing from the standpoint of discretion between those takeovers that it judges to be good for shareholders in a given situation, good for the economy, and those which it judges bad.

Senator METZENBAUM. I see.

Well, there are some who would propose that. This Senator would not.

Mr. GOLDIN. Yes, indeed. As you and I know, appropriately the Federal securities mechanism now requires the SEC to make judgments as to what is good and bad, not so much in the takeover area but as a corporate financial judgment. I urge the committee and the Congress to desist from legislation which would provide that kind of discretion in judging between takovers that are good or bad.

But leaving aside direct legislative dealing with takeovers per se, it seems to me there are appropriate areas for regulation and I have now delineated them a couple of times and I hope they're clear and better understood.

Senator METZENBAUM. I think I do understand your testimony better. I'll put you back on the pedestal. [Laughter.]

Mr. GOLDIN. You never came off yours, Senator. [Laughter.]

Senator D'AMATO. Let me thank the comptroller of the city of New York, Comptroller Goldin and the former banking Superintendent for the State of New York, Commissioner Siebert, for their testimony. I think it certainly will aid this committee in coming up with a legislative initiative that will take care of what I consider to be a legitimate concern and yet not unimpede the capital formation or the ability of people to make offers for the acquisition of corporations that will benefit the economy as a whole and shareholders as a whole.

Thank you very much.

For our third panel we have Andrew Sigler, Alexander Trowbridge, and John Georges.

STATEMENT OF ANDREW C. SIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHAMPION INTERNATIONAL CORP., ON BEHALF OF THE BUSINESS ROUNDTABLE, CHAIRMAN, CORPORATE RESPONSIBILITY TASK FORCE

Senator D'AMATO. Let me ask you if you'd attempt to summarize the written testimony. We'll take your statements as if read in their entirety.

Mr. Sigler.

Mr. SIGLER. Thank you, Mr. Chairman.

I am Andy Sigler, from Champion International and I'm here representing the Business Roundtable.

Our basic position is that the whole takeover phenomenon is causing serious damage to the economic system and I would like to make a few comments on that and then offer our suggestions.

I should add that I feel that the panel's discussion today has been far reaching and stimulating and I'll try not to duplicate. As Mr. Rohatyn said, many of his positions and mine are similar and I will rest on his able testimony in a number of areas.

Our position is that behind the smokescreen of talking about doing good for shareholders and punishing the stupid entrenched management and in using the expression free market in a lot of areas, a basically small group has systematically extracted equity from corporations and replaced it with debt. And, we might add, accumulated rather major fortunes in the process.

DIFFERENCE BETWEEN EQUITY AND DEBT

I think one of the satisfying things to me today is to see that finally in the debate the great difference between equity and debt is understood. The basic structure we use in our economic system is the corporation, whether it's small, emerging, large or whatever. A triple A rating for a company means it has less than 10 percent debt. To take a position that high leverage doesn't count, is we think absolutely crazy.

Equity is the only fuel that a corporation has. Equity is accumulated a little bit at the startup of the company, and occasionally you have the opportunity of selling your stock, but essentially it's retained earnings.

So the accumulation of equity—that is, the billions of dollars that we're talking about extracting—takes place over many, many years. I'd like to emphasize a question that was asked I believe by

Senator Riegle. When money leaves equity it doesn't go back into equity. It goes into the investment market. The $90 billion that Senator Proxmire was talking about which is our number—is money that has been taken out of what is essentially the ability of this economic system to fuel its activities.

Now, it's not just takeover actions that do this; it's all the associated phenomena. Greenmail or restructuring—which in many ways is just a grand scale greenmail—does the same thing that the successful takeover attempt does when it puts debt in the place of equity. At best, it neutralizes the company; at worst it takes segments of industry and major companies and makes them extremely vulnerable in downturns because the leverage situation works both ways very quickly.

The Business Roundtable has not addressed the junk bond phenomenon. Our approach is from the point of view of the leveraging situation. Basically we are talking about an asset play brought about by the ability to get more for a company in the marketplace when you sell its assets than the marketplace values its stock.

In an ordinary business cycle, the stocks of most U.S. corporations go through swings in relation to asset value. Most corporations, are vulnerable to takeovers at some point, and the most vulnerable are those with high cash flows and those which have accumulated good assets. To say you're only vulnerable because of stupid management who doesn't understand how to run a company is too simple. You would have to condemn practically the total economic system to make that generalization.

I'd like to make a couple of comments about the shareholder. Companies the size of the roundtable companies are essentially owned by professional money managers.

We find that the 70–80 percent of our stock that's owned by professional managers, churns. I think on average the funds turn over 65 percent of their stock ownership in 1 year. This has a couple of effects. The pricing by these professionals tends to go on P/E ratio versus current earnings. That's why we get this funny phenomenon of the value of stock on a cyclical downturn of a large business—the value of a company's stock versus what you can get when you sell its assets. That's really why a takeover goes.

I'd also like to comment on the ownership issue, which is a fascinating one. We have owners professional money managers who will feel a responsibility toward the money they're running and not to the ownership.

In fact, uniquely, at the House hearings, the largest professional money manager, Battery March, suggested they would sell their votes because their issue is not in ownership; their issue is in making returns. I think that's an interesting problem.

There's an irony here—most of the professionally manged money today is in pension funds. The security of a pension really has very little to do with the performance on a yearly basis of those pension funds. The security of a pension is the long-term viability and success of the institution that has made an obligation to you for a pension. So to liquidate companies or to liquidate the equity of companies to help pension funds is, I would say—what did Mr. Rohatyn call it—financial craziness. I think we're at least at that.

LOOKING AT FREE MARKET IDEA

The use of the phrase "free market" is another thing that we feel should be looked at. There's nothing "free" about anything we're talking about. To pick up Senator Metzenbaum's comment, everything that we're doing here is controlled, and what we're talking about in our suggestions is changing some rules, not imposing new ones. If we could go back to no Federal controls, I think in many ways we would be more in favor of that.

I think the Unocal decision has gotten a lot of our interest, but I think maybe one of the more important decisions was the one Tuesday in Missouri which threw out as unconstitutional segments of Missouri's antitakeover laws which in effect says there is Federal preemption in a good many areas of this situation.

So a lot of things that you have talked about have to be handled by Federal legislation.

The last comment on free market is that the idea of free market for corporations is a totally novel idea. It's invoking a mantle of something, and it doesn't make any sense from a point of view of what's good for the country. So our position basically is the way the whole process runs today is creating a situation that's not in the public interest, due primarily to extraction of equity, which is another way of saying the high leveraging.

Now, we think the solution is to bring more order out of the chaos. Mr. Rohatyn and I generally agree. We feel that first of all, there has to be a threshold number of shares which you can't go beyond and we have some marvelous examples now of buying gradually over a period of time creates the problem. If you go beyond the threshold, you have to buy all shares or have to go through a process that requires shareholder involvement.

Senator D'AMATO. Mr. Sigler, are you suggesting if a person buys 5, or 6, or 10 percent they may have to do what?

Mr. SIGLER. We think there's got to be—Mr. Rohatyn said his threshold was 20 percent.

Senator D'AMATO. All right, 20 percent.

Mr. SIGLER. What our specific recommendation is, if you go beyond that point, you have to go for all shares, and you have to do it in two ways: You go to the board of directors and if the board of directors approves it, you can make your tender. If the board says no, you have a right to go to the shareholders with a proxy statement and get the shareholders to vote on it. We tend to go toward a proxy situation as opposed to a tender because there is a much better mechanism for disclosure to the shareholder and letting the shareholder vote.

That's essentially our postition, which only modifies a little bit Mr. Rohatyn. Basically, we feel that with a proxy situation there is a better vehicle for everyone to look at and to vote on the tender.

Senator METZENBAUM. Is that just based on disclosure with respect to a proxy battle as compared to disclosure and a tender offer?

Mr. SIGLER. Essentially, yes.

Senator METZENBAUM. Would it possibly be better for Congress to change that part of the law or get the SEC to do it rather than shift a takeover battle into a proxy battle rather than a tender

offer? It seems to me that when one gets down to the basics when you're talking about dollars on the barrelhead, the question is whether the other one is a little bit different or a lot different.

Mr. SIGLER. Well, I think the Rohatyn proposal says you go from 20 days to 60 days. If you do that, then, and put in the requirements of disclosure on financing et cetera, I think we're so close to what we would call the normal process of a proxy, that we would not have difficulty with that.

But the 20 days which is normal, I think one of the interesting situations is in the Turner phenomena——

Senator D'AMATO. Mr. Sigler, I don't mean to cut you off but let's get to Mr. Trowbridge and Mr. Georges or we'll never get through.

[The complete prepared statement follows:]

TESTIMONY OF ANDREW C. SIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF CHAMPION INTERNATIONAL CORP., REPRESENTING THE BUSINESS ROUNDTABLE

SUMMARY OF STATEMENT OF ANDREW C. SIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF CHAMPION INTERNATIONAL CORPORATION, ON BEHALF OF THE BUSINESS ROUNDTABLE

I am here today to express concern about the recent rash of hostile takeovers, to warn of the negative impact this could have on the nation's economy if allowed to continue at its present pace, and to suggest a legislative approach aimed at curbing the current takeover frenzy and restoring order to the tender offer process.

Mergers and acquisitions can be a useful mechanism to maximize efficiency in the marketplace. However, the recent flood of hostile takeovers is being orchestrated by professional raiders whose strategy is to manipulate the system for personal gain. Because the mere threat of a hostile takeover can be highly disruptive to a corporation's ability to function in the best interest of its stockholders, its employees, and the communities in which it operates, some defensive tactics have been devised which are equally as reprehensible as the raider's blitzkreig techniques.

This has led to unacceptable abuses, such as the payment and receipt of greenmail, the putting of companies into play where the object is not to improve the management of the company, but to encourage speculative buying for quick-term profits, the financing of takeovers by borrowing against assets of the target and then liquidating those assets to pay off the debt, and the loading of companies with enormous long-term debt that makes them vulnerable to a later economic downturn. If not curtailed, these abuses could threaten the health of the U.S. economy.

Those who make a business of hostile takeovers contend they are only trying to maximize the values inherent in the target businesses for the benefit of shareholders. But because the current federal regulatory framework is so skewed in favor of raiders, virtually no company -- no matter how efficient or well-managed -- can withstand a takeover attempt and remain intact. Either control of the target company changes hands and the business is broken up and sold off, or the company is drastically restructured to maximize value in the short-term. Either way, the change occurs at the expense of steady, long-term building up of equity. Last year alone, almost $90 billion was taken out of the equity of American corporations and turned into debt.

While raiders allege that target companies are currently undervalued because of mismanagement, the fact is that the stock market is a notoriously inexact measure of the value of companies. The willingness of acquirers to pay more than the market price for the stock does not mean the assets of the company will then be used more efficiently. Whatever additional value there is to be wrung from the acquired enterprise stems from the peculiarity of our tax laws and accounting practices that favor debt over equity.

Generation after generation of American managers have believed that there must be a solid equity basis for an enterprise to be successful in the long term. That healthy conservatism is now being replaced by a new game in which the object is to see how far that equity base can be squeezed down by layers of debt, much of it carrying exhorbitant interest rates. It is because of the danger this situation poses for the future of our economy that the Business Roundtable has reached the conclusion that corrective action must be taken.

Because the Business Roundtable is essentially a conservative organization that rarely appeals to government for legislative or regulatory solutions, I am sure you will believe me when I say that we would rather see a self-correction of the problem through the unfettered operation of the free market. But we have become convinced that this is not possible because of the complex federal regulatory scheme already in existence -- the Williams Act, Hart-Scott-Rodino, the tax code, etc. All of these provisions have been interjected into the marketplace so that it no longer is reasonable to talk about allowing the market to operate freely. Instead, it is necessary to consider changes to the existing regulatory overlay in order to correct abuses fostered by the current system.

The Business Roundtable has a proposal to insure that the takeover process itself becomes more rational and considered. First, a threshold number of shares that a raider may acquire should be established, perhaps at 15 percent, above which the raider must offer to purchase all of the shares of the target company at the same price. Second, any tender offer above the threshold must be submitted to the board of directors for approval. Third, if a majority of the board disapproves, the offer would be submitted to the shareholders for consideration and those shareholders of record on the day before the offer was made would be eligible to vote.

With these relatively simple changes, we believe the current system would improve dramatically. Only those bidders who truly believe they can run a target company more efficiently than its current management, and who are willing to pay a premium for that control, would make tender offers for a company. Those who are in the game today simply to make a quick profit through the receipt of greenmail or through the temporary upsurge in market value created by the possibility of a takeover, would no longer find the takeover game attractive for such speculation. And shareholders, armed with information as to the pros and cons of the offer, would have the last say on whether the offer was in the corporation's best interest.

I ask that you give full consideration to the process-oriented approach to rationalizing tender offers that we are proposing.

Thursday, June 6, 1985

Mr. Chairman, Members of the Subcommittee:

My name is Andrew C. Sigler. I am Chairman and Chief Executive Officer of Champion International Corporation, a major paper and forest products company with more than 50,000 employees and sales exceeding $7 billion. I also serve as Chairman of the Corporate Responsibility Task Force of the Business Roundtable which has been studying the tender offer phenomenon. I am here today in both roles:

- to express concern about the recent rash of hostile takeover activity;

- to warn of the negative impact this could have on the nation's economy if allowed to continue at the present mad pace; and

- to suggest for your consideration legislative approaches aimed at curbing the current destructive takeover frenzy and restoring some semblance of sanity to the tender offer process.

Mr. Chairman, you and your Subcommittee are to be commended for the commitment you have made to finding a solution to this vital national problem. As you continue your efforts I submit that the overriding question regarding tender offers has to be: Is the public interest served?

The nation's economic system is basically one of free enterprise. It is a system which by and large has served our country well. As that system has evolved in the latter half of the 20th century, big corporations have become an integral and important part of the total economic picture.

The country's economy could not function as it does without big enterprises that are large enough to have the assets, the credit and the talent to be able to think and act long term. Such companies can direct their planning, research and financing in ways which may not make them this season's Wall Street darlings, but, hopefully, will enable them to become corporations for all seasons -- companies capable of responding to and meeting the nation's needs through good times and bad. And these are the very companies now being targeted for takeover. Supposedly this is being done in the interest of the shareholders. But what is this doing to the country?

Mr. Chairman, when we talk about the tender offer phenomenon we are not talking only about the interest of shareholders, or job security for corporate executives, or the risk to those who buy junk bonds. We are talking about the country. Whatever affects our economic system affects the whole society.

The Business Roundtable is an organization of chief executive officers of 200 of the nation's largest corporations. It is a group whose interest in tender offers is far from academic. Most are seasoned veterans of one or many mergers and acquisitions. As such we know from hands on experience that mergers and acquisitions can be a useful and productive mechanism which is helpful in maximizing efficiency in the marketplace.

However, some of us have learned first hand, and the others have had many occasions recently to observe, that the mere threat of a hostile takeover can be highly disruptive to a corporation's ability to function in the best interest of its stockholders, employees and the communities in which its plants are located.

The recent flood of hostile takeovers is the handiwork of a new breed: professional raiders. Their strategy is to wage blitzkrieg warfare devised to outflank the corporate board of directors and stampede the stockholders. Some of the defensive tactics that have been devised are equally reprehensible. All of this has led to unacceptable abuses which, if not curtailed, could threaten the health of the U.S. economy. Some of these abuses are:

- o raiders putting companies in play with no intention of keeping them;

- the payment of greenmail;

- creation of a climate encouraging speculators to become shareholders whose object is to see the company sold;

- financing of takeovers by borrowing against assets of the target and then liquidating those assets to pay off debt; and

- loading the company with debt that weakens it for the future.

Hostile takeovers create no new wealth. They merely shift ownership, and replace equity with large amounts of debt. Thus, an increasingly inevitable component of the recent wave of hostile tender offers is, in the words of Chairman Shad of the SEC, "the leveraging of America" and the response of institutions and individuals to the lure of junk bonds.

More and more companies are being pushed -- either in self defense against the raiders or by the raiders once they achieve control -- into unhealthy recapitalizations that run contrary to the concepts of sound management I have learned over thirty years. This type of leveraging exposes companies to inordinate risks in the events of recession, unanticipated reverses, or significant increases in interest rates.

Professor Lowenstein of Columbia Law School has pointed out that:

> We are leveraging American industry as we have not done since the 1920s. The net decline in the equity of nonfinancial corporations was about $89 billion in the year 1984 alone, although 1984 was a profitable year and dividend payout ratios were relatively modest. There are a number of reasons for this increasing reliance on debt financing, but mergers and acquisition are clearly a significant factor.

I'm here today to say: Let's all understand what we are doing to ourselves. I believe it is fiscal insanity for this country to continue down this present path.

Generation after generation of American managers have believed that there must be a solid equity basis for an enterprise to be successful in the long term. This long-term equity base absorbs -- in exchange for the expectation of higher returns -- the perils of depression, product failure, strikes, and all the other dangers that characterize business in a free economy. That healthy conservatism is now being replaced by a new game in which the object is to see how far that equity base can be squeezed down by layers of debt. And too much of this debt is carrying interest rates far in excess of those a prudent manager can possibly be comfortable with.

As it exists today, the federal regulatory framework governing takeovers is so skewed toward the raiders that virtually no company -- no matter how efficient and well-managed -- can withstand a takeover attempt and remain intact. Either control of the "target" company changes hands, or the company is drastically restructured to maximize share value in the short term. Either way, this occurs at the expense of steady, long-term building up of equity.

Even if a target company is able to fend off a raider, it still loses. Often it will have undergone drastic defensive restructuring that leaves it highly leveraged and therefore vulnerable to economic downturns. This penalizes all the company's constituencies: its traditional shareholders, its employees and their families, its customers and suppliers, and the communities in which it operates.

Those who make a business of hostile takeovers contend that they are only trying to maximize the values inherent in the businesses they target for the benefit of shareholders. And how do they do that? By leveraging. By breaking up businesses, selling them off, shutting them down. Speculators make quick, short-term profits out of such takeovers, but employees may lose jobs, pension rights, and other benefits.

This Committee has been exposed to much sophisticated economic testimony purporting to prove that hostile takeovers are economically sound and add value to the American economy. Virtually all of that testimony is built on the premise that hostile takeovers are good because they put money in the pockets of the present shareholders of the target company.

Proponents of hostile takeovers conclude that because of the willingness of acquirers to pay more than the market price for the stock, the assets of the enterprise are put to a more efficient use and thereby the economy is benefited. This is nonsense. Anyone who believes there is no difference between debt and equity in the guts of our economic system just does not understand the economy. Whatever additional value there is to be wrung from the enterprise acquired stems from the peculiarity of our tax laws and accounting practices that favor debt over equity. By using step-ups of basis and fast write-offs for tax purposes, and slow ones for accounting purposes, you can create the illusion that somehow or other a more efficient management has arrived on the scene. But that is all that it is -- an illusion.

The stock market, which is the starting point of these economic analyses, is a notoriously inexact measurer of the value of companies; witness the gyrations during the past decade.

During the mid-seventies, the overwhelming majority of the stock prices of most American corporations substantially undervalued the intrinsic worth of those companies. In the recent past, probably the vast majority of new high-tech companies were vastly overvalued. I submit that to base any policy on the prices at which stocks are trading at a particular time is far too limited a measure.

Mr. Chairman, for the most part, corporation law in this country has been a field occupied and developed by the states rather than the federal government. And under most states' laws the role of the corporate board of directors is crucial. The board and the management they select have the responsibility for the operation of the enterprise. While the law places in the shareholders as a body the power to make such basic decisions as whether the company should merge or sell all its assets or wind up its affairs and dissolve, in most states many of these decisions cannot proceed without approval of the board of directors. Directors are seen as fiduciaries of the shareholders. If, then, a proposal were made to acquire the company, the directors -- acting in their proper role -- would represent the shareholders in seeking the best deal for the shareholders and in gaining agreements which would cushion the adverse impact of the transaction on others with stakes in the corporation -- customers, employees, suppliers, and communities. Often this entailed securing assurances that pension and other benefit plans would be continued, that customer and supplier relationships would be honored, that appropriate measures would be taken in the event facilities were closed.

The tender offer technique evades all these carefully legislated relationships and protections. And in so doing, the basic premises of the corporation system in this country have been undermined. Among these premises was one that shareholders would invest in enterprises with the expectation of profiting from the operations of the business and from dividends and appreciation in the price of their stock, not from manipulation of the stock price. Yes, there were short-term speculators; they assisted the liquidity of the market. But the expectation was that the bulk of shareholders would be in the enterprise on a longer-term basis. Corporations were conceived of as wealth-producing enterprises using resources permanently committed to the enterprise, not as chess pieces to be moved about for the purpose of a quick kill.

I have spent my entire career with one company. Perhaps you will understand my strong belief that a corporation is something more than a collection of assets. Like other institutions, it has intangible worth as well as a complex web of relationships with the society in which it functions. While no corporation should be viewed as sacrosanct, I ask you to recognize the fundamental undergirding these institutions provide in the U.S. today and to look at the chain of consequences which have resulted from the recent rash of bust-up takeovers. I am convinced that we must put due process back in the system.

Once before in this century we lost sight of what business and corporations were all about. That was in the 1920s when -- as now -- the game was playing with corporations rather than running them, and it was dominated, not by entrepreneurs and managers, but by people interested only in fast returns on speculative risks. We all know the consequences of that exercise in corporate game playing. What reason is there to think the end result of this round of the game will be any different?

The Business Roundtable rarely appeals to government for legislative or regulatory solutions. We would rather see a self-correction of the problem through the unfettered operation of the free market. But we have become convinced that because of the detailed federal regulatory framework already in existence, this is not going to happen. Provisions of the Williams Act, Hart-Scott-Rodino, and the Internal Revenue Code so circumscribe the process that it no longer is reasonable to talk about allowing the market to operate freely. Instead it is necessary to consider changes to the existing regulatory overlay in order to correct abuses fostered by the current system.

The Business Roundtable's proposals are designed to insure that the takeover process itself can be made more rational, thoughtful, and considered. While the initial reaction of some persons has been to suggest prohibitions on the current tactics used by both raiders and

managements -- e.g.; greenmail, poison pills, and two-tier offers -- we believe these abuses are merely symptoms of a more fundamental flaw in the process. Symptoms will change from year to year, and new tactics can be devised to replace those which have been banned. Therefore, we believe our process-oriented proposals will bring stability to a chaotic system and will prevent further harm to the long-term economic strength of this country.

We suggest the following ideas for your consideration:

1) An acquirer holding a threshold number of shares, perhaps 15 percent, should be required to offer to purchase all shares of the company at the same price.

2) The Board of Directors must approve or disapprove of the offer within a specified period of time -- 10 calendar days.

3) If the Board approves, the acquisition would proceed.

4) If the Board disapproves, the offeror could request that a special meeting of shareholders be called to consider the offer. Shareholders' votes would be solicited through a proxy statement containing full disclosure of the offeror's financing arrangement and plans for the company as well as the board's reasons for rejecting the offer.

5) A vote to accept would require an absolute majority of the outstanding shares of those shareholders of record the day before the offer was made.

With these relatively simple changes, we believe the current system would improve dramatically. Only those bidders who truly believe they can run a target company more efficiently than its current management, and who are willing to pay a premium for that control, would make tender offers for a company. Those who are in the game today simply to make a quick profit through the receipt of greenmail or through the temporary upsurge in market value created by the possibility of a takeover, would no longer find the takeover game attractive for such speculation. And shareholders, armed with information as to the pros and cons of the offer, would have the last say on whether the offer was in the corporation's best interest.

I am mindful, Mr. Chairman, that numerous other proposals have been submitted to your Committee. Many may indeed have merit but the suggested changes I have just recited would seem to be central to the restoration of common sense to the process of making acquisitions in the corporate world. As I stated earlier, mergers and acquisitions have been, and I hope will remain, useful mechanisms by which corporations can expand and grow and their efficiency and profitability improved. Typically negotiated acquisitions are conducted with careful thought, concern for the corporate constituents, the free exchange of information to assure informed negotiation, and negotiations that provide the surest means of arriving at a price that is fair to all. This process should be contrasted, however, with the situation in hostile tender offers where technique is everything. And, as I see it, that's the mess we are in now.

We hope that through this Committee the Congress will get us out of this mess. The Business Roundtable stands ready to work with you and participate constructively in efforts to achieve the corrective action necessary to preserve and promote the long-term economic growth essential to America's future.

Mr. Chairman, Members of the Subcommittee, thank you very much for the opportunity you have afforded me to appear here today.

Senator D'AMATO. Mr. Trowbridge.

STATEMENT OF ALEXANDER B. TROWBRIDGE, PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. TROWBRIDGE. Thank you, Mr. Chairman. I am pleased to have the opportunity to represent the National Association of Manufacturers, who in its committee on Corporate Finance, Management and Competition, in early April, endorsed a statement of principles and outlined additional areas we think should be investigated.

Our paper doesn't cover all conceivable questions in this complex area but we believe it provides a useful guideline for further deliberations both in the Congress and within the business community, and appended to our statement is a copy of that position paper for inclusion in the record.

As the analysis of hostile takeovers continues we have been disturbed, as has Mr. Sigler, about the extent to which the debate has been focused on the defensive efforts to target companies.

We should be engaged in a comprehensive view of the action of all the parties in a takeover struggle, including the raider and their immediate partners and financial supporters, including the SEC whose job it is to defend the integrity of the securities market.

I will try to summarize the principles of this policy statement. First, nothing should be done in our opinion by way of legislation or regulation to encourage hostile takeovers. Congress is correctly concerned about the value of hostile takeovers to the economy, and evidence of both sides of the question has been presented to this committee. We believe the arguments of those who have questioned their value has outweighed those of the Council of Economic Advisers and others who suggest a market for control of a corporation should be unfettered by any regulatory system.

The conclusions of the Council and others advocating an unfettered takeover of markets are primarily based on short-term stock market analysis. For example, the advocates of a hostile takeover state that they occur because incumbent management, the target, does not utilize the assets of the enterprise in the most efficient manner, resulting in low stock price.

TARGETS HAD EQUITY OF 16 PERCENT OVER 4-YEAR PERIOD

However, Professor Lowenstein of the Columbia Law School has pointed out in other testimony in a study that he conducted showing that the target of hostile takeovers had an average return of equity over a 4-year period of 16 percent, which was substantially better than that of American industry as a whole.

A better understanding perhaps of why hostile takeovers have increased and the key role of takeover artists can be gained from an article in the May 1985 issue of The American Lawyer. The article prints excerpts from a memo by Carl Icahn, a noted raider, written to prospective speculators in 1980. In that memo, he says:

> It is our opinion that the elements in today's economic environment have combined in a unique way to create large profitmaking opportunities with relatively little risk. It is our contention that sizable profits can be earned by taking large positions in undervalued stocks and then attempting to control the destinies of the companies in question by:
>
> (a) Trying to convince management to liquidate or sell the company to a White Knight; (b) waging a proxy contest; or (c) making a tender offer and/or (d), selling back our position to the company.

The memo clearly supports what Professors Lowenstein and Schearer, Law and others have said, that it is clearly the financial manipulators, not the management of the target firm that needs discipline.

What can be done to protect our national securities markets from the kinds of financial brinkmanship described in the Icahn memo?

Not only are integrated corporations at risk but so is our financial system, when the prime purpose of the hostile takeover is to obtain control by use of huge debit buildups with divestiture of assets to repay debt being the next phase of the undertaking. Little of economic value is created in such a scenario.

The second general principle is that the SEC's proper concern should be in the area of full disclosure and guarding the integrity of our securities markets. The SEC's response has been to reduce its enforcement staff from that which existed 5 years ago. And this has occurred even though trading on the Stock Exchange in New York has more than quadrupled during the period and hostile takeovers have increased substantially.

We believe the SEC has been particularly neglectful in failing to make the schedule 13(d) filed by an acquirer the meaningful document the Williams Act intended it to be. Raiders frequently conceal their known intentions with meaningless boiler plate such as holding for investment but may take other action, which has been permitted to be substituted for substantive disclosure. Shareholders, corporations, and the public are entitled to expect that the SEC will fulfill its regulatory responsibilities.

Even more distressing, however, is the extensive insider trading and formations of groups sometimes referred to as wolf packs or whisper groups. Those concerns were recently expressed in a January 25, 1985 New York Times article where it stated that:

> Insider trading, it is believed, has reached sizable proportions and if allowed to continue could tarnish the credibility of the securities markets.

And the only real effort in policing these activities has come from private lawsuits by the target enterprises, which clearly does not have the impact which necessarily flows from Government enforcement.

The third general principle is that there is no need for new Federal corporation law governing the relationship of directors, management, and shareholders.

It would be wrong to replace longstanding State laws and court decisions with a new Federal corporation law as a result of the activities of corporate raiders whose effect on the economy is at best suspect and who operate in a national market which is virtually unpoliced.

In particular, the business judgment rule has been the basis for risk-taking by corporate boards and managers over a number of years and important in the creation of an industrial base and a standard of living we enjoy today.

Indeed, we have witnessed many corporations asking for and obtaining shareholder approval of bylaw amendments which are sensible defenses against the raiding parties.

The actions of these corporations are a part of a growing trend, and are an example of the free exercise of business judgment subject to shareholder approval. The Investor Responsibility Research Center, a research group recently surveyed 750 corporations from Standard & Poor's, Fortune, and Forbes list and found that 136 of these corporations have adopted antitakeover charter amendments in 1985. John Shad of the SEC recently stated that about 200 companies enacted antisuper majority or fair price amendments in 1983, about 400 adopted such amendments in 1984 and probably 600 will do so in 1985.

In this regard, NAM's fourth general principle is that Federal laws and regulations should not be adopted which would restrict a corporation and shareholders' defense against two-tier tender offers. It's entirely appropriate for companies to take action to ensure that all shareholders are treated fairly.

Now one must recognize that hostile tender offers are indeed nonnegotiated take it or leave it offers and that the second tier of a two-tier offer is a nonnegotiated cram down offer forced upon the remaining shareholders.

TIME PERIODS FOR TENDER OFFERS

Regarding the fifth principle of the position paper which states in part that the time periods for tender offers should be extended, the SEC has opposed any time extension. They argue that the extension would discourage a potential raider from ever making an offer because the increased time could lead to a bidding contest, thus increasing the acquisition price.

It seems strange that a nonnegotiated take it or leave it offer should be protected from other bidders. This is not in the interest of the shareholders of the corporation. We believe that the threshold ownership of stock necessary for the filing of a schedule 13(d) should be reduced so that the target, it's shareholders, and the public are made rapidly aware of the accumulation.

Once an acquirer commences his effort to gain control of a target company, many actions occur in the markets and the financial community. Market abuses are virtually inevitable in these situations and the financial exposure of the various institutions is substantial. This whole area needs to be studied carefully.

There is a real basis for concern that financial institutions may be jeopardized by these activities and that the integrity of our national markets may be undermined.

With this in mind, we have recommended specific areas that should be carefully studied. The first such area is whether the net capital and margin requirements within existing legislation or regulations could be made more restrictive in takeover situations.

Those rules were intended to prevent, to the extent possible shocks to the national securities markets which would result from failures based on excessive speculation. We believe these risks exist in the takeover area and are exacerbated by the introduction of high-risk, high-yield junk bonds as a means of financing hostile takeovers.

And we have recently submitted a letter to the Federal Reserve Board stating these concerns and that junk bonds used solely to finance the acquisition of margin securities should be subject to the margin rules presently in place under regulation G. A copy of this letter is a part of our testimony.

Senator D'AMATO. Mr. Trowbridge, I'm going to ask that the rest of your testimony be submitted.

Mr. TROWBRIDGE. Yes, sir.

Senator D'AMATO. Let me ask you one question and then we'll move on to Mr. Georges.

You heard Mr. Rohatyn exactly on point about margins and takeovers and the necessity of utilizing them. He said no to my question, he would not go up to imposing a marginal requirement but rather would see that there be a 100-percent financing, that that financing be there and not by way of a letter or intent to raise money.

Would you be in accordance with his feeling on that?

Mr. TROWBRIDGE. I think the question really deals with the quality of the assurance that is being given.

Senator D'AMATO. We understand that. We're saying, if there were a legislative effort that resulted in that commitment being put forth, not a promise but a tangible commitment for 100 percent of that financing, would that change your opinion?

Mr. TROWBRIDGE. I think frankly 100 percent would be excessive, Mr. Chairman.

Senator D'AMATO. Now wait 1 minute. We're not saying there's a margin, but we're saying there be a real letter of commitment or a letter of credit or whatever suitable instrument, whether it be from a bank or other institution, what would then be the necessity for a margin of 25 or 50 percent? We approached it from the margin position when we asked Mr. Rohatyn, and he said no, not necessary.

Would that change your view?

Mr. TROWBRIDGE. If it were a 100-percent guaranteed cash or——

Senator D'AMATO. 100 percent cash.

Mr. TROWBRIDGE. You obviously are in the best position, given that, to know and have confidence in the securities being offered.

Senator D'AMATO. I mean, somebody can raise 100 percent cash for that security.

Mr. TROWBRIDGE. Then the risk is nominal.

Senator D'AMATO. We'll take the balance of your testimony as if given.

Mr. TROWBRIDGE. Thank you.

[The complete prepared statement follows:]

TESTIMONY OF

ALEXANDER B. TROWBRIDGE
PRESIDENT
NATIONAL ASSOCIATION OF MANUFACTURERS

ON BEHALF OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
SUBCOMMITTEE ON SECURITIES

OF THE

SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

June 6, 1985

Mr. Chairman, members of the subcommittee, I am Alexander B. Trowbridge, President of the National Association of Manufacturers. I am accompanied this morning by James P. Carty, Vice President of the Government Regulation, Competition and Small Manufacturing Department of the NAM.

The National Association of Manufacturers is a voluntary business association of over 13,000 corporations, large and small, located in every state. Members range in size from the very large to over 9,000 smaller manufacturing firms, each with an employee base of less than 500. We estimate that NAM member companies employ 85 per cent of all workers in manufacturing and produce over 80 per cent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

I appreciate the opportunity to appear before your subcommittee today on the important subject of hostile takeovers. The National Association of Manufacturers commends the efforts which the members of this subcommittee have already made to resolve the problems surrounding hostile takeovers. The hearings which this subcommittee held on April 3 and 4 added greatly to the public's understanding of this subject.

On April 10, 1985, the NAM Committee on Corporate Finance, Management and Competition endorsed a statement of principles and an outline of additional areas we think should be investigated. Our paper does not cover all conceivable questions in this complex area but we believe it provides a useful starting place for further deliberations both in the Congress and in industry. I have appended a copy of the NAM position paper and I ask that it be included in the record of this hearing.

As the analysis of hostile takeovers continues, I have been disturbed about the extent to which the debate has been focused on the defensive efforts of target companies. We should be engaged in a comprehensive review of the actions of all of the parties in a takeover struggle. I include that of the raider, plus any immediate partners and financial supporters. I also include the SEC, whose job it is to defend the integrity of the securities market.

As the study goes forward in Congress, the NAM urges close attention to certain general principles. Let me identify these principles and make a brief comment on each. Following that, I want to suggest some additional areas for legislative attention.

Hostile Takeovers Should Not Be Made Easier

First, nothing should be done by way of legislation or regulation to encourage hostile takeovers. Until the total impact of the phenomenon is better understood, we should guard against tampering with present laws and regulations in any way that might actually increase hostile takeover activity.

Congress is correctly concerned about the value of hostile takeovers to the economy. Evidence on both sides of the question has been presented to this committee. We believe the arguments of those who have questioned their value has outweighed those of the Council of Economic Advisors and others who suggest that the market for control of a corporation should be unfettered by any regulatory system. The Council, apparently, sees no harm in having America's companies sold like so many apples on a street corner.

The conclusions of the Council and others advocating an unfettered takeover market are primarily based on short-term stock market event analysis. As you know, the House Energy and Commerce Subcommittee on Telecommunications, Consumer Protection and Finance is also studying the subject of hostile takeovers. The most compelling point made to that subcommittee by Professors F. M. Scherer, Chairman of the Department of Economics at Swarthmore College, and Warren Law, of the Harvard Business School, in testimony is that the economic effects of takeovers have not been looked at over time. And, in the few instances where it has been done, conclusions contrary to those of the Council are found. For example, the advocates of hostile takeovers state that hostile takeovers occur because incumbent management of the target has not utilized the assets of the enterprise in the most efficient manner, resulting in a

low stock price. Thus, hostile takeover activities supposedly police inept managers and return those assets to a more efficient use. However, Professor Lowenstein of Columbia Law School has pointed out to the House Telecommunications Subcommittee that, in a study he conducted, the targets of hostile takeovers had an average return on equity over a four-year period of 16 per cent which was substantially better than that of American industry as a whole.

A better understanding of why hostile takeovers have increased and the key role of takeover artists can be gained from an article in the May, 1985 issue of The American Lawyer. The article prints excerpts from a memo by Carl Icahn, a noted raider, written to prospective speculators in 1980. In that memo he says:

> "It is our opinion that the elements in today's economic environment have combined in a unique way to create large profit making opportunities with relatively little risk... It is our contention that sizable profits can be earned by taking large positions in "under valued" (emphasis added) stocks and then attempting to control the destinies of the companies in question by:
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> a. trying to convince management to liquidate or sell the company to a "white knight";
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> b. waging a proxy contest, or;
>
> c. making a tender offer and/or;
>
> d. selling back our position to the company."

The memo also reveals that Icahn & Co. has already utilized these maneuvers successfully three times during the past two years with returns on capital of between 100 and 250 per cent."

This memo clearly supports what Professors Lowenstein, Scherer, Law and others have said: it is the stock market, not management of the target firm, which has erred and needs disciplining.

This situation is not aided by legislation or regulation that has the effect of encouraging hostile takeovers. Thus, broad legislation directed against any and all defensive measures taken by a target company's board would have such an effect. Rather, the question ought to be: What can be done to protect our national securities markets from the kinds of financial brinksmanship described in the Icahn memo? Not only are integrated corporations at risk, but so is our financial system, when the prime purpose of the hostile takeover is to obtain control by use of huge debt build-ups, with divestiture of assets to repay debt being the next phase of the undertaking. Little of economic value is created by such scenarios.

Proper SEC Concerns

The second general principle is that the SEC's proper concern should be in the area of full disclosure and guarding the integrity of our national securities markets.

The financial community, members of the press, American industry and last year, the State Securities Administrators, have all called for increased disclosure and enforcement of the securities laws in order to maintain the integrity of our national securities markets. But the SEC's response has been to reduce its enforcement staff from that which existed five years ago. This has occurred even though trading on the New York Stock Exchange has more than quadrupled during the period and hostile takeovers have increased.

Further, the SEC has allowed tender offers to proceed which are really not offers because they are conditioned on the raiders being able to secure financing. It is not unlike calling your stockbroker to place

an order to buy 100 shares subject to you finding the money to pay for those shares. Do you think that order would, or should, be executed? Clearly it wouldn't and shouldn't. Yet, it is exactly that kind of offer that the SEC has allowed to proceed in recent takeover attempts involving millions of shares and billions of dollars.

We believe the SEC has been particularly neglectful in failing to make the Schedule 13D filed by an acquiror the meaningful document the Williams Act intended it to be. Raiders frequently conceal their known intentions with meaningless boilerplate (such as, "holding for investment but may take other action") which has been permitted to be substituted for substantive disclosure. Shareholders, corporations and the public are entitled to expect that the SEC will fulfill its regulatory responsibilities.

Even more distressing, however, is the extensive insider trading and formations of groups sometimes referred to as "wolfpacks" or "whisper groups". Those concerns were recently expressed in a January 25, 1985, New York Times article where it is stated that "insider trading, it is believed, has reached sizable proportions and, if allowed to continue, could tarnish the credibility of the securities markets." More recently, in an April 29, 1985 editorial in Business Week, it is suggested that:

> "Many people will take risks, but nobody wants to be fleeced. A lot of potential investors would stay away from a market they perceived as dominated by people acting on the basis of secret information. This could impair the ability of business to raise equity capital."

The only real efforts at policing these activities have come from private lawsuits by the target enterprises which clearly does not have the impact which necessarily flows from government enforcement. It almost seems that the SEC believes that no form of regulation should prevail where hostile tender offers are concerned.

State Law Should Govern Corporate Conduct

The third general principle is that there is no need for new federal corporation law governing the relationships of directors, management and shareholders.

It would be wrong to replace longstanding state laws and court decisions with a new federal corporation law as a result of the activities of corporate raiders whose effect on the economy is at best suspect and who operate in a national market which is virtually unpoliced. In particular, the business judgement rule has been the basis for risk taking by corporate boards and managers over a number of years. It has been important in the creation of an industrial base and the standard of living we enjoy today. It would be a mistake to now conclude that the states and the state courts are incapable of dealing with the issues which arise from hostile takeover activity. Indeed, we have witnessed many corporations asking for, and obtaining, shareholder approval of by-law amendments which are sensible defenses against raiding parties.

Two recent examples are the by-law amendments of Allied Corporation and Waste Management, Inc. On April 29, 1985, the Allied shareholder meeting adopted a staggered board proposal and a fair price amendment.

On May 24, 1985, the Waste Management shareholder meeting adopted three provisions: a provision which eliminates a shareholder consent action without a shareholder meeting; the enactment of a staggered board of directors; and the adoption of an anti-greenmail provision. The actions of these corporations are part of a growing trend. The Investor Responsibility Research Center, a non-profit research group recently surveyed 750 corporations from Standard and Poor, Fortune and Forbes lists and found that 136 of those corporations have adopted anti-takeover charter amendments in 1985. John S. R. Shad, Chairman of the Securities and Exchange Commission recently stated that about 200 companies enacted anti-supermajority or fair price amendments in 1983, about 400 adopted such amendments in 1984 and probably 600 will do so in 1985.

Federal Law Should Not Prohibit Defenses Against Two-Tier Offers

In this regard, NAM's fourth general principle is that federal laws and regulations should not be adopted which would restrict a corporation's (and its shareholders') defense against two-tier tender offers. Such offers are inherently exploitive and serve to coerce and stampede shareholders into tendering shares of their company for fear of being left with a lesser-valued, second-tier offer forced upon a minority shareholder.

Hostile takeover techniques which attempt to facilitate a change in control without offering all shareholders fair and equal treatment should be discouraged. It is entirely appropriate for companies to take action to ensure that all shareholders are treated fairly.

We must recognize that hostile tender offers are "non-negotiated take it or leave it" offers; and that the second tier of a two-tier offer is a "non-negotiated cram-down offer" forced upon the remaining shareholders.

Time Periods Should Be Extended And The Threshold For Schedule 13D Filings Renewed

This leads to the fifth principle of the NAM's position paper which states in part that time periods for tender offers should be extended. The SEC has opposed any time extension. They argue that an extension could discourage a potential raider from ever making an offer because the increased time could lead to a bidding contest, thus, increasing the acquisition price. It seems strange that a "non-negotiated take it or leave it offer", should be protected from other bidders. This is not in the interest of shareholders of the corporation.

The change of control of an American corporation should not be a decision made in haste. Requiring adequate time periods for full review of the complex issues associated with the determination of corporate value is more important than the acquiror's interest in speed.

The NAM also believes that the threshold ownership of stock necessary for the filing of a schedule 13D should be reduced so that the target, its shareholders and the public are made rapidly aware of the accumulation. Adopting and enforcing such a rule would reduce, to some extent, the insider trading apparently rampant in hostile takeover situations.

In 1980 the SEC recognized the inequity to shareholders of the "creeping tender" whereby an acquiror purchased a controlling interest over time without making a formal tender offer to all shareholders at a uniform price. The proposal prohibited acquisitions of a target's stock exceeding 10 per cent unless a formal tender offer was made. Why this proposal was abandoned is unknown. The concern at the SEC for a fair price available to all shareholders reflected by such a proposal seems to be out of favor.

Activities in the Financial Markets

Once an acquiror commences his effort to gain control of a target company, many actions occur in the securities markets and the financial community. Entering the market along with the acquiror are traders and risk arbitrageurs. They are backed by substantial loans or commitments from financial institutions. Market abuses are virtually inevitable in these situations and the financial exposure of the various institutions is substantial. This whole area needs to be studied carefully. There is a real basis for concern that financial institutions may be jeopardized by these activities; and that the integrity of our national securities markets may be undermined.

Financial institutions have historically functioned to provide the necessary capital for the long-term growth of America's businesses. Whether diverting funds to hostile takeovers impedes or endangers this essential flow of capital should be carefully reviewed.

Net Capital Rules and Margin Requirements

With this in mind, NAM has recommended specific areas that should be carefully studied. The first such area is whether the net capital rules and margin requirements within existing legislation or regulations should be made more restrictive in takeover situations.

The risks inherent in arbitrage speculation are exemplified by the situation following the withdrawal of Gulf Oil's bid for Cities Service in August, 1982. It was estimated at that time that trading losses by arbitrage firms betting that Gulf would go through with its bid could climb to as much as $400 million. The New York Stock Exchange was sufficiently concerned to canvass member firms to determine their potential losses and that no member's capital position was impaired. Robert Bishop, executive vice president of the Exchange was quoted as saying, "there will be massive losses but they shouldn't be critical". There was also concern that many individual and professional traders faced margin calls which would touch off active selling in many securities. Fortunately, in this instance, the question of whether the losses were merely "critical" or terminal did not have to be answered -- severe consequences were avoided as Occidential Petroleum, within the ensuing week, offered to purchase Cities Service.

The net capital rules and margin rules were intended to prevent, to the extent possible, shocks to the national securites markets which would result from failures based on excessive speculation. We believe these risks exist in the takeover area and are exacerbated by the introduction of high-risk, high-yield "junk bonds" as a means of financing nostile takeovers. In this regard, the NAM has recently submitted a letter to the Federal Reserve Board stating these concerns

and that junk bonds used solely to finance the acquisition of margin securities should be subject to the margin rules presently in place. A copy of this letter is attached.

We believe a thorough review of this area needs to be undertaken to insure that the brokerage and financial community is not undertaking excessive risks which ultimately are underwritten by the U.S. taxpayer, through the FDIC, FSLIC, Federal Reserve Board, Federal Home Loan Bank Board, Securities Investors Protection Corporation or other federal programs. It would seem particularly important at this time that federal funds not be used to underwrite speculative financial adventurism.

Role of Institutions

The second area for further study is the role of institutional investors in the hostile takeover situation. More than half of the ownership of companies listed on the New York Stock Exchange is now held by institutional investors.

Pension funds have been created to provide long-term security for the pensions of both current and former employees. The basis for this security is a sound economy able to grow and compete in the long-term. The management and investment policies of these funds should be consistent with those goals. Given the size of these funds and the extensive ownership of corporate securities represented in these funds, their policies can have a far reaching impact. We believe that most funds subscribe to a policy consistent with those goals. However, we also believe certain activities are clearly inconsistent with those goals. For example, questions should be raised whether any trust fund

should or could invest in stocks on the basis of takeover rumors. Another area for concern is participation in risk arbitrage, short-term risk taking operations, which may be inconsistent with the prudent investment of these pension funds.

We are also concerned that the power exercised by a small group of money managers driven by short-term goals may have a negative effect on the long-term vitality of American industry.

Congress should consider how the views of the beneficiaries and the grantors of those trusts can be reflected in hostile takeover situations.

Astonishingly, the SEC, has suggested that it would be wrong -- because it is a defensive tactic -- to permit employees who beneficially own shares of their company's stock in a company savings plan trust to determine the disposition of their stock. Certainly, there should not be a governmental mandate to achieve quick short-term profits by requiring shares held in trust to be tendered to any acquiror.

A similar disregard for beneficial owner-shareholder rights is seen in the recently reported statement of Dean Le Baron, chairman of the SEC's Advisory Committee on Tender Offers and head of Batterymarch Financial Management. He suggested that institutional money managers should be able to sell or at least rent out their voting rights to the highest bidder during proxy fights. Among other things, this could put the destiny of a corporation in the hands of persons totally unconcerned with what is best for the enterprise. Whether this suggestion was serious or not, it does point out the importance to the money manager of putting or keeping a company in play.

Who Puts a Company "In Play"

NAM believes that how, why, and at whose invitation a company is put "into play" demands serious investigation. An aspect of the events described in The American Lawyer article, entitled "The Roaring Eighties" is the quest of Ivan Boesky, a noted arbirtaguer, and Drexel Burnham Lambert Incorporated, a major investment banking firm, out looking for a "stalking horse" to mount a takeover of Phillips after T. Boone Pickens had discontinued his efforts in this regard. All of it seemed to be based on the simple desire to keep the company in play in order to keep its stock price up long enough for Mr. Boesky to avoid major arbitrage losses. How widespread these activities are is unknown since little public investigation into this question has been undertaken. However, when the rewards are huge, as the Ichan memo indicates, you can expect these efforts to be widespread.

Distorted Credit Markets

The NAM Committee also believes the question of distortion in the credit market is an area for further examination. For instance, does institutional investment in high-risk, high-yield junk bonds for hostile takeovers squeeze out the high-risk venture capital needed for new ideas, products and services? Certainly, we should not thwart the entrepreneurial spirit that creates new products and services in favor of financial gamesmanship and speculation.

We are also concerned, as the SEC was in 1980, about the conflicts which exist in the banking institutions when loans are made for hostile takeovers of clients which have regularly provided detailed confidential

information to those institutions. The SEC was cognizant of this problem in 1980 and proposed legislation to deal with it. Why their concern has changed is unknown but the situation still exists as evidenced by the Unocal suit against the Securities Pacific Bank.

We are also concerned about the long-term effect of the huge debt incurred by a company as a result of current speculative takeover efforts. The NAM is concerned that the required payment of this debt has and will reduce funding for research and development programs, capital spending and other corporate programs. There must also be serious consideration given to the effect a recession might have on the company's ability to continue paying this debt.

The current drive to secure short-term stock gains at the expense of converting equity to debt could set the stage for serious repercussions to our financial markets. Congress is and should be concerned with this situation.

I have outlined the recommendations for further review adopted by NAM. These recommendations should not be interpreted as suggesting the exclusion of other areas for review which primarily come under the jurisdiction of this subcommittee. As you know, other Committees are looking at areas under their jurisdiction, such as the Senate Finance Committee's consideration of the tax code, and the Senate Judicary Committee's review of the antitrust laws and Hart-Scott-Rodino Act enforcement. We commend these efforts.

Mr. Chairman, I submit that there are still important questions to be answered regarding abuses in hostile takeovers. I urge that it is time to look carefully at the people who are making these bids, how they do this and why. It is time to ask the SEC why the present rules and regulations aren't being enforced. And it is time to ponder the consequences of excessive speculation in our financial markets. Thank you.

Recommendations Regarding Hostile
Takeovers for Control of Corporations

Approved by the Committee on Corporate
Finance, Management and Competition

of the

National Association of Manufacturers

April 10, 1985

Preamble: The unprecedented number of hostile takeovers and the increasing size and relative importance to the economy of the corporations under attack raise public policy issues of major national concern. The National Association of Manufacturers urges a careful study of all aspects of this phenomenon to consider whether legislation is desirable and what its content should be. Throughout the inquiry and ensuing debate, NAM urges consideration of the following principles which it believes should be the foundation for any public policy initiatives in this area.

A. General Principles:

1. Hostile takeovers should not be encouraged by legislation or regulation.

2. The SEC's proper regulatory concerns should be in its traditional areas of ensuring full disclosure and guarding the integrity of the national securities markets.

3. State statutory and case law should continue to govern the relationships of directors, management and shareholders.

4. Two-tier tender offers are coercive and Federal laws and regulations should not be adopted which unfairly restrict a corporation's defenses against such offers.

5. Time periods for tender offers should be extended and the threshold for 13D filings should be reduced.

B. Areas Recommended for Further Congressional Investigation:

1. Margin requirements and net capital rules should be reviewed in the context of takeover situations.

2. The impact of large institutional investors on the stock market and takeover activity should be reviewed. Related inquiry should include: (a) whether the increasing short-term orientation of pension fund managers affects the takeover process and (b) how the views of pension fund beneficiaries -- the American worker -- can be reflected in the activities of pension fund managers.

3. How, why and at whose initiative is a corporation "put into play"? What role do arbitrageurs play? What risks are brokerage houses and other financial institutions exposed to by arbitrageurs?

4. Whether and the extent to which credit markets are distorted by the credit demands arising from hostile takeover activity.

C. DISCUSSION OF GENERAL PRINCIPLES

1. Hostile Takeovers Should Not Be Encouraged By Legislation or Regulation

Under present laws and regulations, there has been a dramatic increase in the number and size of hostile takeovers. There is no evidence that beneficial hostile takeovers have been unfairly frustrated in the market. Indeed, there is no conclusive proof that hostile takeovers have been beneficial to the companies involved or to the economy of the country as a whole.

In perspective, the increase in hostile takeovers may be detrimental to the country and its economy; and the NAM urges that there be more analyses and studies to determine the impact of these developments.

2. SEC Regulatory Concerns

The SEC's orientation should be to its traditional concerns for full and fair disclosure by all parties and the integrity of the national securities markets. The SEC should increase its efforts to enforce existing laws, rules and regulations. For example, Schedule 13D was designed to provide the market and all shareholders with information about stock acquisitions and the intent of the acquiring party. In fact, it has fallen woefully short of its goal. The boiler plate of "holding for investment but may take other action" is essentially meaningless, and in many cases misleading, as acquirors continue to accumulate stock at market prices, a process shortly followed by an effort to secure control of the target.

The SEC should be alert to the inequity to the small, unsophisticated shareholder which this situation presents and intensify its enforcement efforts accordingly.

3. Corporate Conduct Should Remain Subject to State Law

The federal government should not attempt to supplant, through the SEC, long-standing substantive state law affecting corporations with a new federal corporation law. Relations among officers, directors and shareholders of a corporation have long

been governed effectively under state laws. The "business judgment rule", which holds that business decisions will not be second-guessed by the courts absent a showing of self-dealing or other breach of faith, has been administered effectively by state courts. The business judgment rule has functioned well for the many decades since its inception and should continue to be the subject of state jurisdiction.

4. Two-Tiered Offers Are Inherently Coercive and Corporations Should Be Able To Defend Against Them.

Two-tiered offers treat target company shareholders differently by proposing a premium price to shareholders who tender their shares early. Such offers are inherently exploitative and serve to coerce and stampede shareholders into tendering control for fear of being left with a lesser-valued, second-tier offer available to a minority shareholder.

Fair and equal treatment of shareholders demands that the corporate valuation proposed by a takeover represent a single price available to all shareholders. Techniques for acquisition which attempt to facilitate a change in control without offering all shareholders a fair and uniform premium are contrary to public policy and should be discouraged, and it is entirely appropriate for companies to take action to ensure that all shareholders are treated fairly.

5. Time Periods For Tender Offers Should Be Extended And The Threshold For 13D Filings Should Be Reduced

The change of control of an American corporation should not be a decision made in haste. Requiring adequate time periods for full review of the complex issues associated with the determination of corporate value is more important than the acquiror's interest in speed. There is no reason not to lengthen this period unless it is to cater to the short-term interests of stock traders and arbitrageurs. Public policy in this area should be directed towards providing enough time to recognize and realize the true value of corporate assets. Twenty days is wholly inadequate to achieve this result and the SEC should accordingly amend its rules.

Knowledge of the fact that stock is being accumulated by any person or entity is material market information. Therefore, consideration should be given to reducing the threshold for stock holdings requiring the filing of Schedule 13D.

D. DISCUSSION OF AREAS FOR FURTHER CONGRESSIONAL INQUIRY

Once an acquiror begins on a course of acquiring control of a target company, many actions occur in the markets and the financial community. Entering the market along with the acquiror are traders and risk arbitrageurs. They are backed by substantial loans or commitments from financial institutions. Market abuses are virtually inevitable in these situations and

the financial exposure of the various institutions is substantial. This whole area needs to be studied carefully to ensure that financial institutions are not jeopardized by these activities and the integrity of our national securities markets are maintained.

Financial institutions have historically functioned to provide the necessary capital for the long-term growth of America's businesses. Whether diverting funds to short-term ventures impedes or endangers this essential flow of capital should be carefully reviewed. In addition, Congress should review whether the tax code now provides inappropriate advantages to hostile takeovers financed by high-risk, low-rated securities ("junk bonds").

With this in mind, we feel the following specific areas should be carefully studied.

1. Margin and Net Capital Requirements Should Be Reviewed in the Context of Takeover Situations

Margin requirements and net capital requirements might well be made more restrictive in takeover situations. Certainly, any review of the takeover phenomenon by Congress must include a thorough review of the financial risks of banks, brokerage houses and the stock market itself in takeover related activities. The potential for the failure of a major Wall Street firm could have very serious repercussions for the financial community and our national securities markets.

2. Impact of Institutional Investors; Pension Fund Management

More than half of the ownership of companies listed on the New York Stock Exchange is now held by "institutions": pension funds, mutual funds, money management firms, bank trust departments and insurance companies, for example. A far greater proportion of the daily trading volume in recent years is accounted for by these institutions' trading with each other. The role and activities of these insitutional investors in hostile takeover situations should be the subject of Congressional review.

The relative success of pension fund managers have been, for the most part, calculated on the basis of the performance of their funds over a short period of time - typically portfolio growth over a three month period. There are grounds for suggesting that a longer period would more accurately reflect an investment's economic performance, as opposed to short-term stock price swings based on transitory factors. Such a change would better reflect the long-term goals of pension funds. This has created a short-term orientation on the part of many pension fund managers. The question is whether as a matter of policy, pension funds, which represent a significant ownership of America's corporate assets, should be managed for the short term.

Further, these huge pools of capital are under the control of a relatively small group of people whose short term market objectives may not coincide with the views of the beneficiaries of those trusts - the American worker. Congress should study how the views of those beneficiaries can be reflected in the actions of the fund managers. It should be recognized that a duty is owed to the beneficiaries -- not to a raider or a stock trader whose interest is to ensure that the tender offer game continues. Pension funds represent an enormous concentration of economic wealth and power. The management of these funds -- their investment policies and consequent ability to influence the equity stability of companies -- must be thoroughly examined.

3. Target Company Selection; The Role of Arbitrageurs

An inquiry should be made into how and why a company is "put in play". Who decides this? What changes in the process are necessary or desirable? What trading abuses occur in this connection?

The question of the extent to which arbitrageurs expose cooperating investors (including banks, savings and loan companies, brokerage firms, pension funds, etc.) to excessive financial risk should be closely examined in any inquiry into tender offer legislation. Are these risks appropriate for such institutions? Is the "service" performed by arbitrageurs to the economy equivalent to the risks presented by their activity?

It should also be asked if the mere introduction of arbitrageurs into a takeover contest does not in itself provide a spur to the takeover and an assurance that it will be successful, either to the present contestant or to one who will follow. Often the arbitrageur's activity is essential to the success of takeover efforts.

4. Credit Market Distortion

Although the SEC Advisory Committee on Tender Offers concluded that the hostile tender offer was "a valid method of capital allocation", the question deserves thorough examination in any responsible legislative inquiry. Chairman Paul A. Volcker of the Federal Reserve Bank, among others, has suggested there may well be some "crowding out" of the credit market to some companies seeking funds for expansion, as lenders vie for an opportunity to share in the greater short-term rewards of hostile takeover activity. In addition, firms taking on huge amounts of debt to further takeover ventures, or in response to one, may find themselves unable to borrow funds to develop their business once the takeover has been effected or avoided.

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NAM
National Association
of Manufacturers

ALEXANDER B. TROWBRIDGE
President

May 2, 1985

The Board of Governors of the
Federal Reserve System
20th Street and Constitution
Avenue, N.W.
Washington, D.C. 20551

Re: Enforcement Of Regulation "G"
In The Context Of Takeover Financing

Gentlemen:

This letter sets forth the view of the National Association of Manufacturers with respect to enforcement of Regulation "G" in light of recent hostile corporate takeover developments.

The NAM is a voluntary business association of more than 13,000 corporations, large and small, located in every state. Our membership ranges in size from very large to more than 9,000 small manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council. NAM members have an obvious interest in the effectiveness and stability of our nation's financial system.

On April 10, 1985, the NAM's Committee on Corporate Finance, Management and Competition adopted a statement of general principles dealing with hostile takeovers. That paper also made recommendations as to areas for further Congressional investigation, including a recommendation for review of margin requirements as they relate to the substantial risks to the financial and securities markets presented by hostile takeover transactions.

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Margin rules were adopted to ensure that the securities markets were not subjected to abrupt distortions because of excessive leverage in stock transactions. Such distortions could seriously impair the integrity of the national securities markets, cause stockholders unnecessary losses and undermine economic confidence.

In the April 16, 1985 petition of Unocal Corporation, the Board of Governors of the Federal Reserve System is squarely faced with a question which could have serious long-term impact on the effectiveness of the margin rules in sustaining the purposes for which they were intended. Petitioner seeks interpretation of Regulation G as it relates to the issuance of high-yield, high-risk debt instruments ("junk bonds") by "Newco", a shell corporation created by Mesa, to lenders for the purpose of financing the acquisition of Unocal common stock (a margin security).

The only question is whether the loans to Newco are "indirectly secured" by the margin stock within the meaning of Regulation G. The term "indirectly" in Regulation G means that the rule is to be applied on the basis of the economic realities of financial arrangements. Here the reality is that Newco's only assets are shares of margin stock; the loan can only be repaid from the proceeds of the sale of that stock and the dividend income from such stock.

That Newco's margin stock is not legally pledged to the junk bond lenders and that the junk bond lenders have no loan agreements containing limitations on Newco's right to encumber or dispose of the margin stock, would not as a practical matter alter the economic reality. The lender is relying on Newco's ownership of the margin stock -- there are "no other assets...to support the indebtedness" (5 FRRS 917.12).

Directly applicable is the reasoning in the Federal Reserve Staff's August 11, 1981 statement, 5 FRRS 917.12, that where loans are made to a corporation whose assets consist almost entirely of margin stock, the loan is presumptively made in reliance on the stock and is "indirectly secured by stock".

In the factual situations presented to the Federal Reserve Staff where the Staff found that loans were not "indirectly secured" (two letters, copies of which are attached to the pending petition), the tender offer was to be a cash offer for any and all shares of the target company; and there was a stated intention to merge the shell corporation into the target, paying cash for such shares as may not have been tendered.

But the Mesa offer is only for shares which, together with existing holdings of the Mesa group, would equal 50.1% of the petitioner's stock; and there is no obligation in the offer to purchase the balance of the stock for cash.

In a 100% cash tender offer situation such as in the two Federal Reserve Staff letters, it could be argued that the potential market distortion effects are minimal because, by the terms of the offer, all of the stock is being taken off the market for cash; the stock will be delisted and no longer traded.

By contrast, there is every expectation that after the Mesa/Newco tender offer 49.9% of the petitioner's stock will continue to be traded for some time. The risk of large liquidations of the stock and the destabilizing effect of such sales is present, with the concomitment potential for extensive losses to the financing institutions involved since the transactions are not supported by required equity capital.

When and if Mesa/Newco can obtain the remaining Unocal shares and on what terms, are open questions. A "back-end" merger may or may not be done. In a word, the Newco loans are highly speculative. Here the economic realities for the junk bond lenders are that they must look to the Unocal shares held by Newco as the means of servicing and securing their debt. The economic realities are that junk bond loans are indirectly secured by margin stock.

The speculative risks to the national markets, with which the margin rules were intended to deal, are present in this situation. This matter also raises a genuine policy issue that should be dealt with. Given the continued shocks to our national markets from the granting of speculative credit, it is incumbent on the Board, under existing regulations, to avoid further

excessive risks which could, as some commentators have suggested, create the same economic disruptions that gave rise to the margin rules in the first place.

The threat to the integrity of our national securities markets posed by highly leveraged hostile takeovers are many and serious. Obviously, there is no one simple answer which will solve all the problems. But, the Board's enforcement of Regulation G, as proposed by the NAM in this letter, would certainly be a welcome step in the right direction.

Sincerely yours,

Alexander B Trowbridge

A. B. Trowbridge
President
National Association
of Manufacturers

Paul H. Elicker

Paul H. Elicker
Chairman and President
SCM Corporation
Chairman, NAM Committee on
Corporate Finance,
Management and Competition

THE AMERICAN LAWYER

HEADNOTES

BY STEVEN BRILL

The Roaring Eighties

In the midst of his stormy battle for control of Phillips Petroleum, New York takeover artist Carl Icahn offered a revelation right out of a Hollywood script: "[T]here was a fellow, somebody that calls me up every once in a while, and . . . says he represents some tremendous money. . . . And I have no idea who the hell it is," Icahn recalled in a February 19 deposition, the contents of which have, until now, been sealed. "He has my private phone number," Icahn continued. "I don't know how the hell he got it. . . . And he called me once in January when I went down to Palm Beach. . . . He seemed to know where the hell I was, and everything. The thing interesting about it was that he seemed to know a lot of things that are going on. I have no idea how he knows it."

Icahn went on to testify that the phantom had been calling since the early 1980s and had provided important information and encouragement during a string of takeover battles that has seen Icahn take gutsy stock positions in various companies only to be bought out by competing bidders or in "greenmail" payments by management. The phantom, Icahn stated, seemed "to know too much. . . . I mean during the period with the whole OPEC thing, with oil up and down . . . he seemed to be able to predict what the oil prices would be, what was going to happen at the OPEC meetings . . . ."

According to Icahn, one reason he persevered in his ultimately profitable battle with Phillips was that his caller said he'd buy out Icahn's Phillips stock if Icahn found himself stuck with it. "This guy . . . said his group, [a] very big group [with] big power, is going to make an offer for my stock. So I said, 'Who the hell are you?' He said, 'When the time comes, you will know.' . . . He didn't give me inside information about the company but he knows the facts backwards and forwards about the company. . . . Normally, I wouldn't talk to people like this, but there is something about it that makes me stay with it. Plus it helped me in Marshall Field [one of Icahn's most celebrated raids], so I do it. . . . "

The caller promised, Icahn continued, that " 'as much money as you have and can raise, it is nothing compared to what we can do.'

"[T]he only reason that I . . . lend some credence to it," Icahn reiterated, "is that he really knows the company. . . . I pride myself in being an analyst. . . . I think I know Phillips probably better than anybody outside of Phillips and probably a lot better than many of those inside. This guy knows it better than I do . . . He knows a lot more than any arbitrageur would. . . . "

Bizarre stuff, this account from the man who this winter destabilized the nation's sixteenth-largest publicly held industrial company by threatening to float the largest financing in takeover history, and who is part of a pack of what detractors call "takeover entrepreneurs" who seem to create wealth out of nothing for shareholders and themselves, while terrorizing a group of establishment executives, many of whom, says Icahn, "only come off the golf course when I buy their stock." And it would, indeed, make a terrific script—the all-knowing, all-powerful voice on the phone guides our straight-talking, anti-establishment, up-from-the-streets-of-Queens hero as he brings arrogant, bloated managements to their knees, all on behalf of the forgotten shareholders.

If that seems fanciful, there's still more in the Phillips takeover fight worthy of a good screenwriter. In fact, the whole Phillips episode seems to be part of, or maybe the embodiment of, a fantasy era we now seem to be living. Were it a soap opera, we could call it *The Roaring Eighties*.

In *The Roaring Eighties* everyone gets rich quick. In *The Roaring Eighties* credit is there for the asking because the era's magic word—leverage—is always a good thing. In *The Roaring Eighties* there are no nervous Nellies at the SEC worrying about fraudulent or incomplete filings or insider tipping, because, again, everyone is getting rich. In *The Roaring Eighties* 30- and 40-year-old money managers who think in time horizons of two hours to two weeks control industrial America. In *The Roaring Eighties* "independent" lawyers call people like Icahn extortionists and racketeers in one brief, then call him a hero in the next writing, after he's hired them. In *The Roaring Eighties* many "independent" investment bankers act with all the independence and loyalty of ladies of the night. But nobody cares much because, again, everyone is having a terrific time and getting filthy rich.

Yet even with all the fun and games, this soap opera is dead serious stuff, and it may not have a happy ending. Because what's really going on here—what went on in the Phillips brouhaha—is that the forces and people that shape American and world business are undergoing a fundamental shift and steering us into an uncertain future. Thus, among the characters in *The Roaring Eighties* are an insistent bunch of party poopers who complain with what some think is annoying persuasiveness that *The Roaring Eighties* will end like the Roaring Twenties.

Let's look in on the action:

1. OPENING BID FROM THE SEDUCTIVE TEXAN

On December 4, 1984, an affiliate of Mesa Petroleum, a small, Amarillo, Texas–based oil company run by a folksy character named T. Boone Pickens, announces that it has acquired 5.8 percent of the shares of Phillips Petroleum, and that it will soon begin a tender offer to buy another 14.9 percent of the shares for $60 each. The Phillips stock is selling today for $44. Although Mesa is a about one thirty-seventh the size of Phillips, its takeover threat seems to be real. Why? Leverage!

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Pickens sits at Mesa behind a barbed-wire net of anti-takeover protection devices, plus a fabulous golden parachute at the ready should the protection fail. In other words, in a rational world he'd be cast as a selfish, entrenched manager. Yet he has instead become the media's favorite liberator of oil companies plagued by entrenched managers; and his bid is generally played in the press as a $60-per-share offer that will give Phillips shareholders the value that its management has withheld. This, we shall see, is a man who has managed to turn a Texas drawl, a gift for a great quote, and near-total press *accessibility* into near-total press *credibility*.

Pickens declares that once he buys the additional 14.9 percent he will try to gain control of Phillips, and that if he succeeds he will then propose a merger or some other combination, in which the remaining 79.3 percent of the shareholders will receive some unspecified combination of cash and securities having a value "approximately equal" to $60 per share as determined by "independent bankers selected by [Mesa]." He goes on to say that Mesa has "not formulated any specific proposal" and that "there is no assurance that any such transaction will be proposed."

If that reads like a $60 offer for a $37 stock, read it again. Pickens is promising no transaction at all beyond his tender offer for 14.9 percent of the shares, and he's saying that if there *is* a transaction it will be one full of debentures that his "independent" bankers will value at approximately $60.

Nonetheless, based on Wall Street's belief in the Texan's magic touch the stock shoots up to $48 by the end of the day, and to $53.50 the next day.

Pickens also promises the press and the Street that he'll never take greenmail—a special buyout of his stock to get him to go away—because he's in this fight on behalf of all the shareholders.

2. THE RESCUE SQUAD

Phillips CEO William Douce, 65, is a gruff, no-nonsense (and some say dictatorial) plodder who has worked his way up through the ranks. As Pickens is quick to point out, Douce presides over a company whose stock has been trading at an aggregate value of about $5 billion. Yet its book value—the value of its assets including its oil reserves—is something over $10 billion.

The stock has been trading low, we will hear Pickens (and later Icahn) argue, because Phillips is a sleepy, poorly run company that is deploying its assets badly.

The stock is down, we will hear Douce's team argue, because oil exploration and other long-term ventures have their ups and downs and don't always show up in stock prices over the short term.

They're both probably right.

After hearing of Pickens's bid, Douce leaves the soon-to-be-celebrated Phillips headquarters town of Bartlesville, Oklahoma, and repairs to New York, where he assembles a fight team of bankers from Morgan Stanley and First Boston. Morgan Stanley is to get up to $20 million if Pickens is fended off, but only $2 million if he wins; First Boston is to get up to $15 million if Pickens is defeated and only $4 million if he isn't.

Counsel also need to be hired. But Douce finds he can't turn to Joseph Flom of Skadden, Arps, Slate, Meagher & Flom, whom he has long had on retainer, because Flom has also worked for Pickens. Citing the conflict, Flom bows out of the fight. (Investment bankers are obviously more in the swing of things in *The Roaring Eighties* than lawyers; Morgan Stanley gladly takes on the Phillips business and begins the attack on Pickens, who is a former client.)

Instead of Flom and Skadden, Arps, Douce hires Martin Lipton and his troops from Wachtell, Lipton, Rosen & Katz. This, we will see, is fortuitous to our plot development. In the past Lipton's and Flom's firms were seemingly interchangeable in takeover fights; neither seemed to care much which side it took. But now, with this fight, Lipton crowns his firm as a raider defense specialty house, the unquestioned market leader in such exotic wares as the "poison pill." Flom, on the other hand, hates the pill and says he won't use it.

Lipton is like a quarterback calling audibles from scrimmage. State and federal suits are filed in Delaware, Oklahoma, and Louisiana. Complaints are filed with the Federal Trade Commission, the Securities and Exchange Commission, and the Department of Justice. None of it is likely to work. Lipton tells his numbed client, but it may buy some time. The claims include the charge that Pickens's "$60 offer" is fraudulently illusory—which it may be, but which no one from the Phillips side ever tests by agreeing to Pickens's repeated requests to sit down and discuss the details of his "back-end" offer to the remaining 79 percent of the shareholders. "We told them we could take the whole company out at $60," says Pickens. "But they were afraid to talk to us. They knew we could do it."

When a board meeting is held to reject the Pickens offer and adopt a slew of anti-takeover bylaws, the minutes read quite a bit like the paper record that Lipton's how-to-do-it articles and memos recommend to boards fighting a takeover.

In fact, as we watch the team of bankers and lawyers going to work, it seems that Phillips has already been taken over—by them. As one Phillips executive will later recall, "From the minute Boone struck, Marty Lipton, with help from Joe Fogg [of Morgan Stanley], and Arthur Reichstetter [of First Boston], were running this company. They were leading Bill [Douce] around by the nose. Writing his press releases. Telling him what kinds of stock and notes to issue. Telling him what to say and to whom. Telling him what to divest."

Lipton's people also claim in one suit that in the past Pickens has tipped off his friends at the Amarillo Country Club about some of his raids so that they could buy the stock beforehand. This claim, like the others, isn't likely to win an injunction, though it should be noted that when the Wachtell, Lipton lawyers, who had brought the suit only on rumor, begin taking depositions from Pickens's friends, they find two men who admit buying stock or options before Pickens announced raids. But the two maintain that the purchases weren't based on tips from Pickens, and Pickens vehemently denies that he tipped off any friends. "In Amarillo, Texas, there are as many amateur arbitrageurs as anyplace in the world," Pickens says. "I can't tell you that some people didn't buy any of those stocks. But why would I tip them off?"

3. THE RESCUE PLAN

It is Sunday, December 23. After more than a week of meetings and negotiations with Pickens (in which Flom acts as an intermediary), Lipton and crew come up with a complicated plan that the Phillips board dutifully approves.

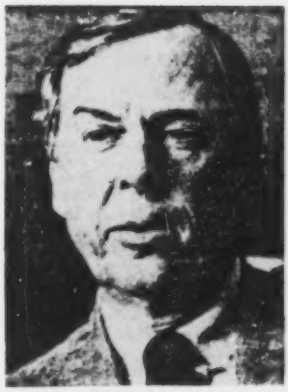
The scheme, called a recapitalization plan, would give shareholders a new package of debentures supposedly worth $60 a share for 38 percent of their stock and allow them to sell $1 billion worth of other shares back to the company for as much as $50 per share, in cash. Moreover, new shares totaling 32 percent of the stock would be issued—in lieu of some future employee wage increases—to an employee stock ownership trust, which presumably would forever vote in favor of management. When combined with other friendly shares, this employee stock trust would give management effective control over the company.

Where's Phillips going to get the money to buy back those shares and support all that new debt? Easy: The company is going to sell $2 billion worth of unspecified assets and cut capital expenditures—this from a company that had attacked Pickens's bid because it would cause Phillips to sell off assets and cut long-term capital expenditures, and a company that had spent more than $3 billion in recent years to make Douce and crew's empire bigger, by buying General American Oil and R.J. Reynolds's Aminoil subsidiary.

Phillips also announces that although it's not interested in a sale to anyone, it will put aside its recapitalization plan and take $62 a share in cash for all shares if anyone is interested.

When Phillips announces the plan, it claims the package is worth $53 a share—which is better than Pickens's $60, they say, because his bid is illusory.

As for Pickens, there's an announcement about him, too: He's agreed to take a $53 deal from Phillips for the stock he's already bought. Only there's one catch: Pickens, despite his repeated protests that he'll never take greenmail or any other deal not offered to all the shareholders, is guaranteed the $53 in *cash*. Plus he's been given $25 million in "expenses" he's supposedly incurred in mounting his now-aborted effort.



Mesa's T. Boone Pickens: Taking greenmail while attacking greenmail.

Thus, Pickens has made a quick $89-million profit on his purchase of Phillips stock. Moreover, because he has also bargained for all litigation to be dropped, he has avoided any possible embarrassment from wide disclosure of the depositions suggesting tipping or insider trading.

On the heels of the announcement of the Pickens buyout and the recapitalization plan, Phillips stock plummets from $54.88 to $45.25.

Although Wall Street analysts quickly set a value of $45 to $50 on the recapitalization package and the stock hovers at $45 to $46, Pickens maintains, with a straight face, that his $53 cash sellout is not greenmail but only a different form of the same deal offered all the shareholders. (One of the great features of our soap opera is the ability of so many people to keep straight faces in situations like these.)

At Mesa, Pickens enjoys a barbed-wire net of anti-takeover devices and a golden parachute, yet he is cast by the media as the liberator of oil companies plagued by entrenched managers.

Phillips and Pickens are quickly sued in a shareholder class action. Among the complaint's more persuasive points is that the Phillips board had said it would take $62, yet when Pickens offered $60 for some of the shares, the board was not willing even to sit down with him to see if it could get him to offer $60 (or $61 or $62) in cash or its verifiable equivalent for all the shares. In effect, as one arbitrageur later put it, the board had instead said to the shareholders, "We think the stock is worth $62; we won't listen to his $60 to see if it's real; and we want to force you to take what we say is $53 from us in a package that the market says is really worth $45 and that, with the employee trust getting so much stock, forever forecloses the possibility of another bid."

But the suit in Delaware state court is doomed; the law there is that a board of directors can exercise its "business judgment" pretty much as it sees fit as long as it's not grossly negligent.

4. ENTER ICAHN

In *The Roaring Eighties* Carl Icahn's résumé reads like the model career path: He started out as a stock trader, graduated to arbitrage, and then decided that rather than take arbitrage risks anticipating other people's raids he'd gamble on a sure thing—that *he* would do a raid. That is, he'd buy stock and watch it jump as he threatened a takeover.

Phillips's William Douce: His defense team took over the company.

As Icahn enters center stage, the camera flashes back to a confidential memo he wrote in order to recruit prospective partners in 1980 (which was one of the exhibits in a court record recently unsealed at the request of *The American Lawyer*). In the memo Icahn summarizes his *modus operandi*:

> It is our opinion that the elements in today's economic environment have combined in a unique way to create large profit-making opportunities with relatively little risk. . . . It is our contention that sizable profits can be earned by taking large positions in "under valued" stocks and then attempting to control the destinies of the companies in question by:

a) trying to convince management to liquidate or sell the company to a 'white knight';
b) waging a proxy contest, or;
c) making a tender offer and/or;
d) selling back our position to the company.

"Icahn & Co., Inc., has already utilized these maneuvers successfully three times during the past two years," the memo continues, pointing out that the returns on capital from these "maneuvers" had so far been 100 to 250 percent.

By now, five years later, the several dozen partners whom Icahn recruited for various forays with memos like this one include a small circle of ever-richer relatives, close friends active in garment-center and other small businesses in New York, and other stock speculators—including Cincinnati-based Marvin Warner. (Warner's Home State Savings Bank set off a near-disastrous chain reaction when it failed in March.) There's also one foundation among Icahn's partners, The Carl C. Icahn Foundation. Drawing on tax-deductible contributions from Icahn and an Icahn-controlled corporation, the foundation—which, according to its publicly available tax filings, has contributed only minor portions of its assets or income to charity—has invested in at least one of its namesake's limited partnerships, a practice that, depending on regulatory interpretations, might violate Internal Revenue Service regulations limiting such self-dealing.

With these partners in tow, Icahn has now gone after 14 different companies. And he has taken option d)—greenmail or some variation of it, such as selling to a third party whose purchase was arranged by the target company—nine times. He has forced the target into the clutches of a white knight three times. In the two cases where he gained control, he quickly achieved partial liquidations.

So in the reception area at Icahn's Sixth Avenue office, we find 14 neatly framed covers of annual reports—among them those of Marshall Field, Gulf & Western, Dan River Mills, Owens Illinois, and Simplicity Pattern—each trumpeting a quick money triumph.

Icahn could also have another wall full of framed documents: SEC consent decrees he has collected in earlier fights for five of the 14 target companies. And if even a fraction of the additional charges of securities law transgressions made against him in court by his targets before they'd caved were true, he arguably deserved a few more.

If the wall were large enough, he could also include a slew of demerits from his earlier days as a stock trader and arbitrageur: a consent order from the New Jersey Bureau of Securities, a censure from the New York Stock Exchange, a consent agreement with the New York Stock Exchange, an Assurance of Discontinuance from the New York state attorney general's office, and four decisions by the Chicago Board Options Exchange fining Icahn's company for options trading irregularities.

By all accounts, including those of his executive quarry, Icahn is relentlessly singleminded once he starts a fight. In many instances, he unabashedly asks for greenmail. He is always willing to bargain through all hours of the day and night down to the last dollar, frequently seeming to go along with one price, and then prolonging things for hours, claiming he has changed his mind. And he prides himself on negotiating without lawyers, thinking he can best any of his target CEOs one on one (which he probably can). In one deposition, Icahn recalled that when Marshall Field's chairman didn't call him back to agree to a negotiating session, he himself called again because he was "beginning in some way to sort of feel that surge of battle a little bit."

Yet there's something appealing about Icahn—perhaps his obvious, sheer intelligence and confidence in himself as a lone player in an arena where everyone has layers of advisers. There's also his candor. If, as enemies and even friends say, he is one of the greediest men on the planet, he is also in his way delightfully greedy, stripped of all pomposity and pretense. In one suit over his fight for Dan River (which bought him out and went private), Icahn testified, when asked about his prior greenmail payoffs, "I'm not a Robin Hood."

On December 27, 1984, two days after the announcement of the Phillips recapitalization plan and the accompanying buyout of Pickens, Icahn and his web of partnerships and corporations begin buying Phillips stock. The price is about $45.

"I got into it," Icahn will later explain in an interview, "just because I figured something would happen. I thought there really wasn't much risk because the board's offer was too low. They'd have to raise it, or someone would have to come in and better it." Icahn would soon be that someone.

5. THE GROUP

The scene shifts to northern Westchester County and the Bedford, New York, estate of Ivan Boesky, the fabled arbitrageur. It's a Saturday in January. We are about to see that arbitrage in *The Roaring Eighties* may not be as risky as it's cut out to be.

Boesky, like most arbs, has had a horrible Christmas season. Boone Pickens's sellout has threatened to cost Boesky millions; he reportedly bought Phillips stock in the $50s in anticipation of Pickens's deal—or a better one—going through, only to watch the stock drop to the mid-$40s when Pickens was bought out.

Boesky has invited Icahn, who has an estate nearby, to discuss the Phillips fight.

According to Icahn's later deposition,* Boesky had called him a few days earlier and said, "I hear you are involved in Phillips." At the time, Icahn's stock purchases were supposedly secret and certainly not a matter of public record; and the information would be gold to Boesky, who presumably could be buying back Phillips stock at its now-lowered price in hopes of evening out his position should a new Phillips suitor appear.

"I think I said, 'Yes, I bought some stock,' but I really don't recall," Icahn testified.

Boesky told me in a February interview that he had "never, ever" spoken to Icahn "about any deals or stocks we're involved in." He otherwise declined all comment about his Phillips trading.

Icahn further testified that during their telephone conversation Boesky said he felt the Phillips situation was ripe for a proxy fight. The two then decided to set up the Saturday meeting.

At this meeting (attended by three other people—an Icahn aide, a Boesky assistant, and a broker from Shearson Lehman/American Express—according to Icahn's testimony), Boesky shies away from joining Icahn in a Phillips fight, but urges him on. Icahn replies that he doesn't like simple proxy fights; rather, he prefers tender offers combined with proxy fights, because while they may be riskier, they put more pressure on the target.

**This February 19, 1985, deposition, taken by lawyers for Phillips, was sealed by the court. However, after I initiated court proceedings to unseal Icahn's deposition in the 1982 Dan River fight and made it clear that I would pursue a similar course with this deposition, Icahn's lawyers made both available to me.*

Ivan Boesky: Met with Icahn to discuss Phillips, then denied talks took place.

"Did you discuss at what price a tender offer should be made?" Icahn was asked in the subsequent deposition.

"I don't remember going into that. Maybe, but I don't remember it," he replied.

"Did you discuss how much money would be needed for a successful tender offer for Phillips?" he was asked.

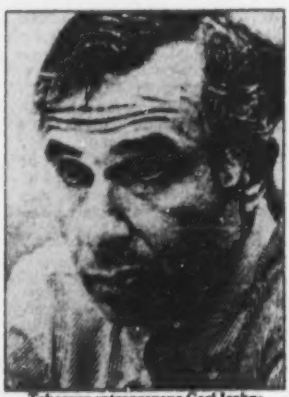
"All of this must have come up," he answered. "I remember generally we talked about all of these things, but I don't remember any more.

"Then later on, Ivan [Boesky] kept calling me," Icahn added.

According to Icahn's deposition, "a few other" arbitrageurs were in contact with him, either before he announced a bid for Phillips or soon thereafter. But the clannishness doesn't stop there. When asked in the deposition about whether the subject of financing a Phillips tender offer came up in his chat with Boesky, Icahn replied, "The name Drexel came up."

Drexel, of course, is Drexel Burnham Lambert Incorporated, America's preeminent junk-bond dealer. (More on that later.) And, according to one Drexel banker and to other deposition testimony, it was Boesky who brought up Drexel's name to Icahn. Indeed, Drexel, according to other deposition testimony, had thought up a leveraged junk-bond scheme for a Phillips tender offer and "was looking for someone to do it," says the Drexel banker.

Arbitrage may not be as risky as it's cut out to be. According to Icahn, he and Boesky talked about a proxy fight and tender offer for Phillips well before February 4, when Icahn made his bid.



Takeover entrepreneur Carl Icahn: "I'm not a Robin Hood."

"One guy we started with was Ivan, because we knew he'd been burned by Pickens and figured he might try to sell it to someone else even if he didn't take it himself, which is just what happened with Icahn."

"Yes, we talked to Boesky before we talked to Icahn about a financial package for a Phillips takeover," confirms David Kay, head of mergers and acquisitions at Drexel. "It was our package, and we were trying to interest someone in it . . . I probably talk to Ivan everyday," he says.

In short, Boesky, an arbitrageur with a need for inside information (Is there any other word for secret information about a possible tender offer?) was out discussing, perhaps even encouraging, an Icahn tender offer formulated by Drexel. And Drexel, of course, could have been passing that same information on to any of its other stock speculator clients, too—not in the traditional and black-letter sense of tipping someone off with inside information, but in the context of asking people to consider the deal for themselves, while mentioning that Icahn was seriously considering it.

"These arbitrageurs and takeover entrepreneurs and people from Drexel are a ring, pure and simple," asserts one takeover adviser. "They feed on their own inside information and cooperation, and to believe anything to the contrary is to be ridiculously naive."

According to Icahn's deposition testimony, Boesky sold him 2.74 million shares of Phillips on January 28. But, his testimony continues, 11 days later, on February 9—five days after Icahn announced his bid for Phillips—he and Boesky met again, this time over dinner at Icahn's house. At that meeting they discussed the fact that Boesky had bought another 4 million Phillips shares.

Had Boesky bought the shares before Icahn's bid, but after their January discussions when he had learned that Icahn was contemplating a bid, thereby taking advantage of that information? Had Boesky done any trading *at all* in Phillips stock during the time he was discussing with Icahn and Drexel the plan for a tender offer? Asked these specific questions, Boesky again declined all comment on his trading activities, citing longstanding "Boesky company policy," except to say, "I seem to detect an insinuation that such trading would in some way be wrong . . . or improper, which I find kind of unattractive . . . and offensive coming from a responsible publication." Was Icahn's deposition about their discussions accurate? "I really don't think I should comment on that," Boesky replied, "except to say that I wonder whether it is proper or legal for you to publish something like [the deposition], and that it would be foolish and not nice of me to sit here and take potshots at what a friend of mine has said under oath, whether it's true or not."

According to Icahn's testimony, after that February 9 meeting at Icahn's house, Boesky "was on the phone with me every day." The arbitrageur, of course, had a big stake in knowing what Icahn was doing and how he was faring.

It is about this time, according to Icahn's deposition, that Icahn gets those mysterious late-night phone calls cheering him on in the Phillips fight. Is it an arbitrageur? Is it someone from Drexel Burnham? Is it someone else?

6. ICAHN'S MAGIC OFFER

It is now February 4, 1985. A messenger delivers a letter from Icahn to Douce, via Morgan Stanley. Icahn begins by telling Douce that he owns 7.5 million shares of Phillips—or about 5 percent, purchased for about $350 million—"which makes me one of the company's largest shareholders."

"I have examined the material you have sent me concerning [the recapitalization plan] and find it grossly inadequate," Icahn's letter continues. Icahn then proposes that he acquire all of Phillips for what he calls $55 per share—$27.50 in cash and $27.50 in a subordinated note. Icahn goes on to say that the financing will be provided by Drexel Burnham Lambert Inc., which is, he says, "highly confident" it can raise the money. Icahn also threatens an alternative: If Douce and his board don't withdraw their recapitalization plan in favor of his offer, he intends to begin a proxy fight to defeat the recapitalization, scheduled to be voted on at a shareholders' meeting in Bartlesville on February 22, and to begin a tender offer for 51 percent of the shares at $55 in cash and what he says will be $55 in debt securities for the remaining 49 percent.

At face value, a $55 bid for the Phillips shares is an $8.1-billion offer for the company. And face value is exactly how the press plays it: Icahn's offer is called a $55 offer.

An attached letter from Drexel Burnham corporate managing director Leon Black repeats the "highly confident" claim and reveals that the financing to be arranged amounts to $4.05 billion, which will cover all of the cash portion of the offer to the shareholders. When all the numbers are added up, this means that if Icahn's plan goes through the company will have just $800 million in stock and about $11 billion in debt. Even considering Icahn's stated plan to sell $3.7 billion in unspecified Phillips assets, this debt-to-equity ratio seems to leave the company hopelessly mired in interest payments, with nothing to invest in research or oil exploration and in grave trouble if cash flow should slow.

After going through the motions of asking Icahn to answer written questions about the offer, Douce and the Phillips board reject it. They also sue Icahn, claiming among other things that his letter to Douce, which he knew the company would have to make public, constituted the sending of proxy material without prior SEC clearance, and that it was false and fraudulent proxy material because of its supposedly unfounded criticism of the board's recapitalization plan.

A few days later, Phillips puts the lie to the bona fides of its first recapitalization offer by sweetening it so that the shareholders get a package the company says is worth $3 more. (The market soon pegs its value at about a dollar more.) More important, the company announces that its board has passed a poison pill.

The dreaded poison pill. It is a Lipton creation of almost diabolical repute. In its various incarnations, it gives shareholders a right to demand all kinds of extra money in the form of debentures, or rights to sell their stock to an acquiring company, or rights to buy an acquiring company's stock if an acquirer buys more than 20 percent (or, in some cases, 30 percent) of a company. Its stated purpose is to prevent partial two-tier takeover bids by allowing the remaining shareholders to make life miserably expensive for the acquirer, a problem eliminated in most of the pills if the acquirer buys out all the shareholders, because then the acquirer owns whatever misery-causing rights that shareholder had been given.

In this incarnation, Lipton's pill allows shareholders to redeem their shares for $62 in debentures the moment anyone buys more than 30 percent of the company. In other words, Icahn would be buying into a company where everyone—except him, because the 30 percent buyer somehow is discriminated against and doesn't get these rights—would have a $62 debt package. Depending on your point of view (or your stock position), Lipton's pill is an ingenious way to make sure the shareholders get what the company is worth, and aren't stampeded into selling out cheap; or it's an outrageous usurpation by management of the shareholders' rights to decide on Icahn's offer for themselves, with management having set an unrealistically high price—$62—and having cleverly come up with a way (this pill) to make all the shareholders stick to it, just so management can't be thrown out in a takeover.

This pill is adopted less than three weeks after a Delaware court has decided that a similarly intended, though differently configured, Lipton pill aimed at saving Household International from a possible raid is perfectly legal.

The camera now shifts to any February morning at the Regency Hotel in New York, where Joe Flom or others from Skadden, Arps can be found arguing, persuasively, that Lipton's pill is a patently illegal usurpation of shareholder rights, and that unless the Delaware appellate court (where Skadden will be arguing against the Household pill) overturns the lower court decision, the takeover game may be frozen by this Rube Goldberg monstrosity.

Indeed, at almost every table at the Regency, lawyers, investment bankers, CEOs, and their clients are talking about the pill; and most seem awed by its ominous impact.

"Marty comes up with a new trick, and it's like someone passed legislation," comments takeover expert Arthur Fleischer, Jr., of Fried, Frank, Harris, Shriver & Jacobson one morning over an omelet. "Don't they realize it's a passing fad that has ten antidotes?"

Fleischer doesn't realize how right he is, and how soon we'll all find out that in *The Roaring Eighties* fads like the pill pass quickly indeed.

Underlying the pill and other Phillips defenses is the company's attack on Icahn's offer as unreal because the financing has not been lined up and Icahn won't be able to get it.

7. THE JUNKMEN SELLETH

How can a man who's prepared to spend only $350 million in cash (the cost of his original stock purchases) bid more than $8 billion for a company? Enter Drexel Burnham, the investment banking house where in *The Roaring Eighties* people seem to be having the best time of all. Drexel has led the way in promoting the current darling of *The Roaring Eighties*, the high-risk, high-yield, "junk" bond. The firm's clients include what one top lawyer calls "a murderers' row of takeover raiders"—Saul Steinberg, Carl Lindner, Victor Posner, the Bass brothers, the Canadian Belzberg family, Irwin Jacobs, Sir James Goldsmith, Pickens, Icahn. When a raider is stalking prey, he forms a dummy corporation or partnership, for which Drexel sells these high-yield bonds, which will ultimately be secured by the assets of the company to be taken over. In other words, it's a mechanism for a hostile leveraged buyout: The raiders buy the company with the company's anticipated cash flow.

If the takeover doesn't go forward, the subscribers to the bond still get a commitment fee (paid by the raider) for having pledged their money. In the Icahn-Phillips deal these fees were three-eighths of one percent, or $37,500 for each $10 million pledged.

Drexel's take in these deals is high, even by investment bankers' porcine standards. In the Icahn-Phillips deal, Drexel's retainer letter calls for the firm to be paid $1 million the moment Icahn uses its feared name in any public statement, then 2 percent of all the financing it arranges—or more than $80 million—if the deal goes through. Moreover, if the deal does not go through, Drexel is to get as much as 20 percent of the incremental profit Icahn makes from selling his stock to anyone else, plus one-eighth of one percent in its own commitment fees for the money it has lined up, which would be as much as $5 million.

Drexel's Leon Black: "Highly confident" of raising $4.05 billion for Icahn.

The question of whether Drexel can in fact peddle $4.05 billion in junk bonds for Icahn's deal, let alone whether Icahn really wants to raise the money and take over the company or is just bluffing to force a higher bid from the company or from someone else, is high drama—and the subject of Phillips's newspaper ads attacking the Icahn offer under the headline "Is Icahn For Real?"

The issue is sharpened on February 15. With just a week to go before the vote on management's recapitalization plan, which Icahn has declared the shareholders must reject in order to take his plan, Icahn announces that in just 48 hours Drexel has lined up $1.5 billion. Where have these commitments come from? The very people who have done other Drexel junk-bond raids (such as Steinberg and Lindner), a host of arbitrageurs (though not Boesky) with an obvious interest in seeing Icahn's deal or some new deal go through, plus the kind of high-flying insurance companies or savings and loan institutions that have been Drexel's base in selling these junk bonds.

To explain why these people signed on for junk bonds in a company that was going to be neck-high, or higher, in debt, our camera takes us to Drexel's Beverly Hills sales floor (its West Coast office is the center of junk-bond financings), where eager young bankers under the tutelage of junk-bond impresario Michael Milken, 38, are pushing $1.5 billion worth of bonds in units as small as $3 million.

We then cut to their various customers across the country. Several tell us they're in it because they believe in Icahn's stated plan to liquidate $3.7 billion in assets to slash some debt and to pay down the remaining debt through better management of the remaining assets. They like the yield on their junk bonds—it ranges as high as 16 percent a year, depending on the seniority of the debt—and they're confident Icahn can run the company in a way that will see the debt paid. Can they really believe that Carl Icahn—whose management experience consists of running a staff of 30 and supervising two partially liquidated midsized companies he's taken over in recent years—is going to run a corporation larger than Xerox, Boeing, Westinghouse, or ABC? Can they really believe he's going to get into Bartlesville (where he has promised to keep the company headquarters but where prayer vigils and other demonstrations have been organized against him by fearful, resentful townspeople), let alone know what to do when he gets there?

Others aren't as sure as that about how Icahn will fare, but they feel good about Drexel's assurances, all oral, that there will be a good secondary market in the bonds, or perhaps a fast payoff because Icahn just might liquidate the whole company if he gets control. Still others want to support Icahn's bid because they like the commitment fee and have shares in Phillips that will rise if the recapitalization plan is defeated; and, they're being told by Drexel, a show of support for Icahn will help defeat the plan. At least one whom I interviewed seems to be in it just for the easy commitment fee; he claims he's received tacit assurances from Drexel that the deal is not likely to go through, and therefore he's not likely to have to put the money up. (A Drexel spokeman declines all comment "on our solicitation activities, although you can assume we conduct ourselves in a responsible manner.") Finally, there are Icahn's compatriots—such as Steinberg, who according to a deposition had bought Phillips stock; they apparently have signed on for some variety of the above reasons, along with a desire to help someone who will help them with their next deal.

Drexel's Michael Milken: The impresario of junk-bond financing.

"It's all just a ring, with Drexel at the center," says one lawyer. "Today they go in for a bluff for Phillips, with Icahn as the front guy. . . . And next month it'll be Lindner."

How can Drexel's people be on the phone offering these securities with no written material? We cut to the SEC, where everyone is sleeping. "These are sophisticated investors," a source in the enforcement division at the SEC says, when roused by our question. "They know what they're doing."

We cut to lines of customers waiting for Ohio savings and loans to open in the wake of the chain reaction that savaged their confidence in the banks after Home State Savings Bank—controlled by Icahn's sometime partner Marvin Warner—was so *un*sophisticated that it went under investing in the E.S.M. treasury securities Ponzi scheme that erupted in March. Then we cut to crowds outside the Financial Corporation of America's savings and loan branches in California; until it almost went under, Financial Corporation was controlled by Charles Knapp, who is now committing $100 million, through a second entity he controls, to Drexel's Phillips-Icahn junk bonds. The point is perhaps a bit indirect, but it is real. There are more than a dozen savings and loans, insurance companies, and other financial institutions on whose health millions of Americans depend signed up for Drexel's Phillips-Icahn junk bonds. How sophisticated are the people who run them about gauging risk? Are they so high on the everything-works euphoria of *The Roaring Eighties* that risk evaluation has for them become a sissy's game?

Watching it all, a cynic in the audience might even conclude that, as one lawyer puts it, "it's all just a ring that lines up bluff money, with Drexel at the center. Today they go in for a bluff for Phillips, with Icahn as the front guy. Last year it was Disney with Steinberg"—indeed, many of the same investors drew the same type of commitment fees in Steinberg's Disney greenmail deal—"and next month it'll be Lindner. And then it'll be Charlie Knapp," he adds.

But why hasn't Icahn gotten the full $4.05 billion? Because, he says, he doesn't want to pay the additional commitment fees until he knows that management's recapitalization plan has been defeated. As it is, he has already paid $7.5 million in commitment fees—three-eighths of one percent to the junk subscribers, plus one-eighth of one percent to Drexel. His proxy solicitors are now urging him to up the ante and show more strength; so is Boesky, who is "calling every day," Icahn later testified. But Icahn sticks at $1.5 billion. Is he bluffing? Is Drexel bluffing?

While we're on the subject of bluffing, the camera shifts to the SEC, where once again we find everyone asleep. How else can one explain why this fiasco is being allowed to continue, with Icahn calling this whatever-it-is of his a tender offer? That in itself seems like fraud worthy of an immediate SEC move to enjoin Icahn from proceeding. This isn't a tender offer; it's a request for a gratuitous option. For Icahn has conditioned his offer on obtaining financing, yet he has not obtained the financing, nor is he out there trying to get it, or even promising to try to get it. He's basically saying, "Let me hold your stock for a while and use it to get credibility, while I decide whether to gather financing and go ahead with this."

Wachtell, Lipton has sent letters to the SEC arguing this point, but to no avail. "We figured the people involved in this deal are sophisticated people and can make that decision," our SEC source later explains, ignoring the clear case law that says that a tender offer, to be called such, must be a contractual offer that is binding on the party making the tender offer to buy the shares if the shareholder tenders them, subject only to conditions that are not within the offerer's control.

8. DEFENDING THE ADVERSARY SYSTEM

In these and other legal battles, Icahn is defended not only by his lawyers at New York's 41-lawyer Gordon Hurwitz Butowsky Weitzen Shalov & Wein (plus Oklahoma and Delaware counsel), but also by 280-lawyer Paul, Weiss, Rifkind, Wharton & Garrison. "You go after a company and Marty Lipton starts throwing all kinds of chairs at you, which offends me," says Gordon Hurwitz partner Marc Weitzen, referring to Wachtell, Lipton's host of efforts at injunctions, as well as the poison pill gambit. "It also makes the litigation heavier than a firm our size can sustain," Weitzen adds.

"Once it was clear that the thing started to get messy and we'd need a lot of litigators, I knew we needed a large firm," explains Icahn. "Paul, Weiss had already been retained by Drexel Burnham, so since they were up to speed I figured I'd use them instead of Weil, Gotshal [& Manges], whom I usually use when I need a big firm. And they were very eager to do it for me, so it worked out fine."

In motions seeking temporary restraining orders against Icahn, Wachtell, Lipton and local counsel Crowe & Dunlevy of Oklahoma City and Boone, Smith, Davis & Hurst of Tulsa attack him as a "fast-buck" takeover entrepreneur and greenmailer. Paul, Weiss answers that Icahn's plan represents the best interests of all shareholders, that all the things Phillips is doing to stop him are tricks intended to "rig the forthcoming vote [on the recapitalization plan] with false, misleading, and deliberately confusing proxy material," and that Phillips's "ad hominem attacks [on Icahn] are still another effort to disrupt the proxy process." The camera pans in on the Paul, Weiss letterhead affixed to these arguments.

Then the camera flashes back three years, to another Paul, Weiss brief in another Icahn takeover fight, this one involving Dan River, Inc. But the picture is confusing. For in this brief the firm is accusing Carl Icahn of racketeering and market manipulation, and comparing his announcing his intention to purchase Dan River stock to his buying an "ad in a Danville newspaper . . . stating that he is about to enter Dan River's mill and break the windows . . . unless he is paid $1,000." The brief goes on to argue that Icahn's "entire pattern of buying into companies and threatening a liquidation or a fight for control unless the company pays defendants a premium for their stock (or obtains a white knight to do so), is extortionate or manipulative, and thus constitutes a pattern of predicate RICO acts, from which profits were derived that now are being invested in Dan River. In short, defendants are using tainted money to 'infiltrate' Dan River and should be enjoined from further so doing."

Another flashback shows Paul, Weiss partner Max Gitter tearing into Icahn at a Dan River deposition and, as four different sources remember it, being nearly obsessed with what in his view was the dire threat to lawful business affairs that Icahn represented. As one of the four puts it, "Max was emotionally involved in this case and in what a bad guy Icahn was. I swear to you he was foaming at the mouth at one point, ranting and raving about Carl."

Gitter declines comment on his work against Icahn, except to say that he acted as an advocate for client Dan River "ethically and in ways consistent with the Code of Professional Responsibility's requirements" that a lawyer not make frivolous claims, and that he was not "emotionally involved."

Gitter is not involved in his firm's current efforts on Icahn's behalf, but two other Paul, Weiss partners active in the Dan River defense against Icahn are now working for Icahn on the Phillips deal. The camera now comes back to them. The first, Moses Silverman, tells us that "other than to acknowledge that I went both ways, I don't want to comment." The second, Arthur Liman, says that these kinds of shifts are "routine aspects of the adversary system." Asked how the firm can argue for the bona fides of Icahn's investment today when in the past it took the position that the money he had amassed was gathered by extortion and, therefore, tainted

and forfeitable under the racketeering statute. Liman replies, "Our willingness to argue on behalf of any client is what strengthens the adversary system. We do it because it contributes to the system."

Asked if he minds having lawyers on his payroll who have called him an extortion artist and racketeer, Icahn shrugs and says, "Frankly, I wasn't aware of any of those charges. Who cares? Lawyers'll say whatever they're paid to say. You can't let it bother you. It's all part of this game."

9. THE MONEY MEN

It is February 21, a day before the vote is scheduled on the recapitalization plan. The rules are that Phillips must get a majority to vote *for* its plan; a non-vote, therefore, will effectively count for Icahn's side.

Remember, Icahn is not only soliciting proxy votes from shareholders against the plan, he also has a tender offer pending, which he has now changed to $60 in cash, financed by those junk-bond buyers, for about 45 percent of the shares, and what he says amounts to $50 in notes (which will be lower than even the junk bonds in payment priority) for the rest of the shares. But his tender offer is conditioned on the recapitalization plan being defeated. As for Lipton's poison pill, Icahn has come up with a relatively simple antidote: When soliciting for the tender offer, he's also soliciting for the shareholders' consent to remove the board of directors and replace it with his own board without holding a shareholders' meeting. In other words, if he gathers a majority of the consents, he can have a meeting with himself and install his own board. And, he promises, his new board will immediately abolish the poison pill, enabling his tender offer to go forward.

With Phillips saying its recapitalization offer is worth $53 and Icahn saying it's worth $42, and Icahn saying his offer is worth $55 and Phillips saying it isn't worth anything close to that, and with outside people saying both sides are stretching the truth, where's the SEC?

While we're at it, why hasn't the SEC come down on Phillips for claiming that Icahn intends to "bust up" Phillips and move the corporate headquarters, when for the record he has promised not to move out of Bartlesville, and said he'll sell $3.6 billion in assets as compared to the Phillips plan to sell $2 billion? And why hasn't the SEC made Drexel Burnham file as part of Icahn's group? Drexel, after all, will share heavily in Icahn's profits if he resells the stock. Drexel is responsible for formulating the plan in the first place, and is wholly responsible for financing it. Drexel is wholly responsible for gathering the group who will buy not only all the junk bonds, but also most of the small amount of stock there will be in the company, and who already own enough of the stock to constitute a group for SEC filing purposes. Besides, Drexel, like Icahn, has two representatives on the slate of directors Icahn proposed in his proxy fight.

We cut back to SEC headquarters. The lights are out.

Now we cut to the electorate who, unaided by any apparent SEC policing, will decide the Icahn-Phillips fight. We learn that by now, with all the arb activity, some 60 percent of Phillips shares are controlled by institutions. (The latest studies indicate that institutions now have about 50 percent of all the voting power of shares traded on the New York Stock Exchange.)

Martin Lipton: No more "bust-up junk-bond takeovers" for Wachtell, Lipton.

Who are these "institutions"? Some are the arbs, who have probably accumulated, or been stuck with, about 5 percent that they are ready to vote unquestionably for Icahn. The rest, says one exasperated Phillips lawyer, are "a bunch of brainless thirty-year-old kids who will do anything for the quick buck because their goddamn jobs depend on beating the Standard and Poors every month or every week or every hour."

Actually, some are in their forties and fifties. Other than that, the assessment isn't far off. In random interviews of a dozen institutional money managers who own Phillips stock, I find by and large a surprisingly uninformed and just plain dumb group of voters. Most don't understand the basics of Icahn's offer or Phillips's recapitalization plan, let alone the poison pill or the consent process that would overturn it. But the real point is that they don't care. They just want the company "kept in play," as the phrase goes, meaning they want all options kept open. So they're voting against the recapitalization plan.

In fact, they're voting against the plan on the proxy cards that Phillips is sending out asking for a vote *for* the management plan, rather than waiting for Icahn's cards to arrive. (An injunction had briefly delayed his solicitation.)

The Phillips lawyers and bankers had figured they had the vote locked up, for with the poison pill in place the shareholders had only one alternative—the recapitalization plan. If they voted it down, the pill would seemingly protect Phillips from other offers, and the stock would sink back into the $30s.

Yet as the Phillips people are counting their own proxy cards and seeing all the surprising negative votes—it's unprecedented for one side to have so many of its own cards cast against it—they begin to see that they have misread the electorate. Sure, some public pension funds had announced that they had banded together as a kind of new shareholder rights group and vowed to fight poison pills, implying they'd vote against the recap plan.

"What I cared about," says one pension fund manager, "was that I have a meeting twice a month with my boss, and he goes over my portfolio. I needed to keep [Phillips] in play to get money out of it."

Senator D'AMATO. Mr. Georges.

STATEMENT OF JOHN A. GEORGES, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF INTERNATIONAL PAPER CO., REPRESENTING THE BUSINESS COUNCIL OF NEW YORK STATE

Senator METZENBAUM. Mr. Chairman, I wonder in view of the fact that there's a rollcall—Mr. Georges has his statement—whether we couldn't somehow expedite it so we could get at least one or two questions of all the witnesses before we leave?

Senator D'AMATO. I'll tell you what I suggest. I suggest we have a rolling rotation and if one of my colleagues would like to go on down then we could continue this and I'll take his testimony.

Mr. Georges.

Mr. GEORGES. Thank you, Mr. Chairman.

I am chairman and chief executive officer of International Paper Co., a forest products concern headquartered and incorporated in New York with operations in some 30 States and several foreign countries.

I appear before you this morning as the vice chairman of the Business Council of New York State and as chairman of its policy committee.

The Business Council of New York has 3,200 members from all regions of the State.

My purpose in being here today is simply to make two points:

The existing Federal securities laws and regulations do require reexamination, but I feel what is needed is more in the nature of some basic adjustments in the Williams Act rather than a drastic overhaul or completely new legislation.

STATES' ROLE IN REGULATION

More importantly, I want to focus on an aspect of the subject which I urge the committee to consider very carefully, and that is the important role that the State can play in safeguarding shareholders and employees in their respective States.

Very specifically, there are four respects in which the Williams Act requires modification. The first is that the so-called 10-day window should be closed. There seems to be general agreement on that.

The second has to do with the minimum time period for which the tender offer is to remain open which is now 20 business days. There is no good reason for 20 business days. The Williams Act was looking for disclosure and to give the shareholder plenty of time to consider. It was not to have the early bird catch the worm and, as far as we are concerned, it would make a lot more sense to extend that 20 days to 60 business days as others have said here before.

Senator D'AMATO. Nothing like agreeing in one's positions. Sixty business days?

Mr. GEORGES. Sixty business days.

Senator D'AMATO. Why not 90 business days?

Mr. GEORGES. Well, I'm not going to argue against 90 business days. As I get to the theme I'll try to build my case for you, Senator, in a few moments.

Senator D'AMATO. Mr. Georges, you know we're going to have another day of hearings in addition and I'm not going to try to pressure anybody because I'm going to stay here and we'll come back and listen to the other panel.

But let me make a point—and I've tried not to take an extreme position and let some things come by. But I really have to suggest to you when we start to go from 20 to 60 business days, then I can say why not 90 days? Why not 120 days?

Then we begin to tilt this.

Mr. GEORGES. Well, let me explain why I feel that. I feel fairly strongly about that.

Senator D'AMATO. How many days does 60 business days work out?

Mr. GEORGES. It would be 3 months.

Senator D'AMATO. So, we're saying 90 days.

Mr. GEORGES. Well, that's the amount of time that I go through—let me give you an illustration. If I want to float out a security, I have to work with the Securities Exchange Commission and give them a book this thick [indicating] about what is going on in my corporation—history, what I plan to do, and I have to get their agreement and then my proxy solicitors say, boy, when you get that prospectus out there you better leave it out there so that your shareholders get plenty of time to think about it when you send out proxy materials, you don't dare take a vote in less than 6 or 7 weeks. That's what I have to do, and I just want to raise capital or get a charter amendment approved. And here we're talking about the buying of a corporation and somehow we have to do this in 20 business days.

I'm trying to suggest to you that there are other things that we do as corporations that are not quite as final as selling a corporation and yet our procedures require significant periods of time.

Now, I'm not here to argue with you whether it ought to be 40, 45, 50, 55, 60 or 80, but what I'm trying to say is there's a lot of precedent about time being in the interest of the shareholder.

Senator D'AMATO. And I think to the extent that you say, Senator, I believe that there are administrations that would demonstrate it is necessary to extend it more than 20 days, I think that's correct and I share that sentiment. See, I don't want you to think that I don't share that.

But I just begin to have a concern when people say, you know, at least 60, and you mention we don't want to get into the business of 45 as opposed to 30 as opposed—but if we say lengthening of it for the reasons you have indicated, I think there is much merit in your suggestion.

Mr. GEORGES. And there are a lot of other pluses in what corporations normally do in their everyday business life.

Senator D'AMATO. Just think going from 20 to the 60 may be going a little bit further than is necessary. But I share your concern and it has been raised in a number of times that the period should be lengthened and I share that as well.

I don't think we're going to go to 60 business days. I have to be candid with you, but I think there should be more time. Please continue.

Mr. GEORGES. Third, we should do away entirely with the conditional tender offers. These are frequently the devices to put the target company into play and to exert pressure on management. It is particularly ridiculous to permit tender offers which are made subject to securing the necessary financing. And we have heard a good deal about that today.

Finally, the SEC should tighten enforcement of the existing disclosure requirements. Every 5 percent purchase on which a schedule 13(d) is filed is predictably for investment purposes only and there is no present intention of doing anything beyond that and The Securities and Exchange Commission sits on the sidelines and watches this primarily because they have difficulty in finding any incriminating documents signifying a contrary company intent.

Now, there are some bills which try to deal with this. Senator Chaffee's bill, I think, is a step forward. It explicitly states that, unless the company acquiring shares admits it is seeking control of another company, it cannot in any manner accumulate more than 20 percent of that company for 2 years without first obtaining the approval of disinterested directors of both companies.

In other words, if they say they are only passive investors, then they ought to be passive investors. Once they declare they want to take control of a company and put into effect Hart-Scott-Rodino and the other things that should come into play, then fine, we can go on and get around the game playing of the passive investment.

Perhaps even more important is the 14(d) filing, which deals with the acquisition itself. Usually the acquirer says he has "no present plans or proposals to transfer a material amount of assets of the subject company. Yet the bidder, once control is obtained, immediately begins to dismantle the company. Again, that's something I cannot do. If I need to go out and offer shares, my legal counsel tells me that if your prospectus says this was your plan, you better stick to your plan.

Yet, here people just flout that sort of thing and the Securities and Exchange Commission—and I'm not a lawyer—somehow permits that to happen. Some of bills, I think, deal with that, and I think it's a step forward.

Senator D'AMATO. If you would submit a suggestion with respect to that particular aspect.

Mr. GEORGES. Fine.

[The following response may be found on p. 1274.]

PROTECT STATE CORPORATE LAWS

The other item I wanted to get to, Senator, is the role of the State corporate law and the specific positions of the Business Council we're advocating in New York.

I think others have said there's a well-established body of corporate law in the States that has to deal with the way corporations are run, and we think that ought to be protected.

Now, we recognize that with the advent of the Williams Act that set aside a lot of previous law. The Williams Act tried to resolve a problem—the 7-day special—that we're all aware of, and I think they did a reasonable job. But the Williams Act as it has been interpreted by the court basically has ruled as unconstitutional some of the State statutes. It's a fairly simple thing to rectify if the

Senate or the Congress, would say that it was not the intent or is not the intent of Congress to have the Williams Act construed as affecting anything beyond what it states and that it should not be interpreted beyond that point. I think then we can get a clear clarification of where the Williams Act should be the law and where State corporate law should be the prevailing law.

I think this would be a very useful way to go at it, and I think Mr. Rohatyn said it very well. Congress could choose to do nothing which is one course of action; the second course of action would be to pass legislation that preempts the whole field, and the third way would be to go at it with a scalpel and deal with modification of the Williams Act; it would make it more germane to today's activities and yet also make it clear that there was no intent to, in essence, keep the States from also having a share in regulating the corporation.

It's that approach that we're advocating to you although we would frankly admit the others are also possible.

I won't go through the New York legislation that the Business Council is proposing but basically it is patterned after the laws that have sprung up in many States—Ohio, Maryland, et cetera. There are now about 15 or 20 States that have tried to deal with two-tier offers or control acquisitions, and generally they do a reasonably good job. There just happens to be a cloud over them because of the Williams Act and that clear lack of direction from Congress as to whether it should be applied to these situations.

I guess the other part—I won't take a lot of time. I'll only take a minute or two.

We talk about a free market, which without question is one of the most important assets we have in our country, but yet, I want to submit to you that the ball game is not in Wall Street, and it's not in my corporate headquarters in New York. The ball game is out through America.

In my business it happens to be in all those States where we build plants, create jobs, make the products, and we try to export abroad and try to compete. It's in those 6 million acres we have throughout the country that we have to manage and here is where we get into these long-term decisions that we have to deal with rather than the short-term decisions that too frequently the market tries to deal with.

If I have time, I'd be glad to give you some——

Senator D'AMATO. Mr. Georges, if I might, I have to be down on the floor in 2 minutes. I don't know whether that buzzer is going to go off and I'm going to be recorded as having missed my second vote this year and I don't want to do that, so I'm going to ask that we take a recess and you stay where you are because Senator Proxmire will be back. That's why I sent him down early. He will be back and you can conclude.

Mr. GEORGES. More than happy to do that, Senator.

Senator D'AMATO. OK. We'll take questions from the panel. So we're not in recess; just take a break.

[Break.]

Senator PROXMIRE [presiding]. The subcommittee will come to order. The chairman asked me to continue the hearing, so he'll be

back shortly. He's going to record a vote. As he said, we'll have to have a rolling operation.

I'm not sure where we left off. Have all three of you gentlemen finished your statements?

Mr. GEORGES. Just about finished.

Senator PROXMIRE. Go right ahead.

EFFECTS ON INTERNATIONAL COMPETITIVENESS

Mr. GEORGES. A comment I wanted to make was that there's been an awful lot of discussion here about free markets today, and they are very important to us. But I don't hear enough discussion, when we talk about legislation and even when we talk about tax proposals in Washington, about international competitiveness.

Senator PROXMIRE. About what?

Mr. GEORGES. About the international competitiveness of our industry, which I think ought to be a paramount concern of whatever we do. And yet somehow it never creeps into the discussion very strongly. Let me give you some examples from my view, from Wisconsin, some of which I'm sure you're familiar with. But they are the kinds of things I have to deal with in terms of trying to deal with the corporation in making the right long-term decisions, and yet on the other hand, facing a marketplace which is looking at very short-term performance.

We spent some $4 billion in the last 6 years, $2 billion in major facilities. A major facility would be like $600 million in Louisiana and $600 million in South Carolina, and on and on. It takes 6 years from the planning to the design, to the construction, to the startup of such a facility, and then it may take another 5 to 10 years before you can recover that capital.

So that the time horizon we're dealing with is 10 to 15 years at least; not 2, not 5, but 10 to 15. And during that period of time, that 6-year period, I can assure I would have been better off taking that money and leaving it in the bank and investing it in that way, because during that time, it's costing me money, I'm paying interest charges and what have you; yet it's what I have to do to remain competitive internationally over the long term, which is going to be valuable to my shareholders and valuable for all the rest of our constituencies.

It's difficult to square that with a day-to-day market situation, which is trying to evaluate today's earnings. Yet that's the kind of decision I have to reach. That's magnified many times over when I have to reach those same kind of decisions out on the forestland. There I've got to make a decision when I clearcut forestland. To plant trees might cost me $150 an acre, but then I have to wait some 35 years in the South, 50 to 60 years in the Northeast, and in the West before I have income. And during that period of time I've got operating costs, I have taxes, I've got to worry about fires and pests, before I finally have income, and that's the kind of time horizon I deal with.

If I look at my company on a short-term basis over the last 5 years, there are many times I would have been better off selling it and putting the money in the bank, and I would have earned a

higher return, yet our country cannot survive with that kind of a test placed on our institutions yearly.

Our company and our industry could not survive if the managers took that kind of viewpoint in making the kinds of decisions they must.

The conclusion I want to leave with you is, free markets are important. What we need, however, is a very orderly process, not trying to protect us from competitive forces or even from hostile takeovers, but the process has to be deliberate; it has to be very rigorous, with lots of disclosure up front during the process.

What's going to happen to the company and, you know, let me parenthetically say my employees own 10 percent of my company, and they have a right to know what's going to happen to the company. They have a very personal interest in it, and so that this is what is missing in this process—this whole disclosure of what is the intent? What is the financing? What is the long-term plan of what this buyer wants to do with this company? So that then the shareholders and all the others interested constituencies can bring to bear their judgments on whether this is good or not. And this is the plea, the kind of commonsense approach I think that's needed rather than just, is it a free market alone, because I think there's more to it than just a free market.

Thank you very much.

[The complete prepared statement follows:]

TESTIMONY OF JOHN A. GEORGES, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF INTERNATIONAL PAPER CO.; REPRESENTING THE BUSINESS COUNCIL OF NEW YORK STATE

Mr. Chairman, Members of the Subcommittee:

I am John A. Georges, chairman and chief executive officer of International Paper Company, a forest products concern headquartered and incorporated in New York with operations in some thirty states and several foreign countries. I appear before you this morning in my role as Chairman of the Policy Committee of The Business Council of New York State.

The Business Council is a statewide organization devoted to improving the economic health of New York State. Its membership totals over 3200 member companies from all regions of the state, ranging in size from the largest industrial, commercial and service corporations to the small, emerging corporations which are striving to become the business leaders of tomorrow.

The Council focuses its efforts primarily on state actions which will lead to a healthier business climate for our companies to grow and expand. In doing so, its efforts touch upon a broad array of issues in such areas as tax, environmental, health and labor policy. This year a major area of concentration involved an examination of the State's corporate law as it relates to the issues we address this morning.

I appreciate this opportunity to share with you some of our thoughts and concerns concerning the hostile takeover phenomenon. I have read the statements submitted on behalf of The Business Roundtable and the National Association of Manufacturers, and both manifest an underlying concern regarding some of the longer-term implications and ramifications of hostile takeovers which I very definitely share but which, in the interest of time, I will not echo.

My purpose in being here today is simply to make two points:

1. The existing federal securities laws and regulations do require reexamination in light of the hostile takeover phenomenon, but I feel what is needed is more in the nature of some basic adjustments rather than a drastic overhaul.

2. More importantly, I want to focus on an aspect of the subject which has received scant attention but which your Committee should consider carefully: that is, the important role that needs to be reserved for the states in legislating measures that safeguard their residents -- both as shareholders and as employees -- as well as the communities in which they live and work.

Federal Securities Law Modifications

There are three respects in which the Williams Act, or the regulations promulgated thereunder, require modification. The first is that the so-called "ten-day window" (the ten-day period between the acquisition of 5% of a company's shares and the date upon which that acquisition must be reported to the SEC) should be closed. There appears to be general agreement on this point. This was one of the recommendations of the SEC Advisory Committee on Tender Offers in July 1983, and on May 20 of this year the SEC reportedly agreed to ask Congress for authority to shorten the ten-day time limit. This is already part of Senator Chafee's proposed "Tender Offer Reform Act of 1985" (S. 631), as well as of Senator Metzenbaum's "Shareholder Fairness Act of 1985" (S. 860), and it should be enacted in this session.

The second has to do with the minimum time period for which the tender offer is to remain open, which is now twenty business days. There is no good reason why the time period should be so short. If shareholders were being asked to vote on a proposed corporate charter amendment, or on any kind of a management-recommended corporate restructuring, our proxy solicitors would tell us that six weeks would be the minimum amount of time needed for shareholders to study the proxy

material and make an informed judgment. Anyone who has been reading the full-page ads now appearing almost daily in The Wall Street Journal well knows that tender offers are frequently made subject to numerous conditions, as, for example, securing regulatory approvals and the necessary financing. Furthermore, if the offer is contested, charges and counter-charges are routinely flung back and forth in such a vituperative manner that even a careful reading of the opposing sides' materials frequently generates more heat than light. The only argument I have heard against extending the tender offer period is that it would be unfair to the original bidder, since other bidders would have additional time to surface, perhaps at the behest of the target company. But the Williams Act was not designed to ensure that "the early bird catches the worm," but rather to make certain that shareholders make well-informed investment decisions. That object would be better served if the twenty-business-day tender offer period were extended to sixty days, as has been proposed by Senator Metzenbaum in S. 860. Again, we agree with that aspect of Senator Metzenbaum's proposal.

Thirdly, the SEC should tighten enforcement of the existing disclosure requirements, which can today be avoided with an ease that has made them a laughingstock in the business community. Every 5% purchase on which a Schedule 13D is filed

is, predictably, "for investment purposes only," and no such purchaser ever has any "present intention" of doing anything other than remaining a passive investor. Obviously, if the purchaser's true object is to acquire a large block of stock as quickly as possible so as to exert maximum leverage on the target company, he doesn't want to trigger the Hart-Scott-Rodino filing requirements and the 30-day waiting period prematurely. Inveterate corporate raiders deliberately and repeatedly flout the securities law, while the SEC enforcement division stands on the sidelines and ponders how it can prove a contrary intent in the absence of any incriminating documents (an absence which the raider's skilled attorneys will see to in every case). The only way to change this sorry state of affairs would be to give the disclosure requirement some teeth, such as by providing, as do several state statutes, that a 5% shareholder cannot acquire any significant number of additional shares for six months to one year from the date on which he last disclaimed any present intent to seek control of the company.* Senator Chafee has made a similar proposal in S. 631 by providing that, unless the Schedule 13D explicitly states that the company making the filing is seeking control or 20% ownership of the company which is the subject of the filing

* See, for example, the Massachusetts statute discussed in Agency Rent-A-Car, Inc. v. Connolly, 686 F.2d 1029 (1st Cir. 1982).

(i.e., the target), such company cannot in any manner acquire control or 20% ownership of the target for 2 years without first obtaining the approval of the disinterested directors of both companies.

The Role of State Corporate Law

I will now address the role of state corporate law and will discuss the specific positions the Business Council is advocating in New York. For many years, state corporate law has regulated the respective roles of shareholders, directors and officers in managing and directing the affairs of domestic corporations. Any fundamental change in corporate structure -- such as a decision of management to merge with another corporation, to sell all or almost all of the corporate assets, or to liquidate operations and dissolve the company -- has typically required the approval of both the board of directors and the shareholders. In New York, for example, the holders of 2/3 of the outstanding shares must agree to any of these three proposed courses of action before it can be implemented. It is a basic principle of corporate governance that the directors are fiduciaries, elected by the shareholders to represent their interests in all but the most momentous decisions, and, as to those, all of the shareholders have the opportunity to speak

for themselves. The Business Council's position is that the hostile tender offer, as it has evolved, is designed to be an "end run" around those basic corporate governance principles, and that state corporation law can and should be modified so as to defend against that tactic.

However, the role of the state in regulating tender offers is one that is presently shrouded in controversy, largely because of developments that took place in the decade after the Williams Act was passed in 1968. The primary purpose of the Williams Act was to protect investors, and it was thought that the best way to ensure that objective was to make certain that shareholders were sufficiently informed as to the terms of the tender offer and management's assessment of it, and had adequate time to make an unpressured judgment as to whether they should tender their shares. The legislative history further indicates that its sponsors wanted the Act to be neutral as between the bidder and the target company, so as not to tilt the balance in favor of either.

In a ten-year period after 1968, thirty-seven states passed laws governing acquisitions of stock in corporations in which the particular state felt it had an interest, whether because the corporation was incorporated or headquartered

there, or had substantial assets or a significant number of shareholders in the state. These state statutes typically modified and supplemented the disclosure provisions of the Williams Act, required pre-disclosure filings with some state official (generally the securities commissioner), and then gave that official the opportunity to call a public hearing on the proposed stock acquisition and to pass on the substantive fairness of the offer. In a number of instances, these statutes were challenged by bidders, usually on the ground that they violated the supremacy and commerce clauses, and in nearly every such instance they were declared unconstitutional by the federal district and circuit courts. Finally, in June 1982, the Illinois statute was declared unconstitutional on commerce clause grounds by the U.S. Supreme Court (in Edgar v. MITE Corp., 457 U.S. 624 (1982)), and after that decision most states, including New York, simply abandoned any effort to enforce the takeover statutes still on their books.

Shortly thereafter, however, like the proverbial phoenix, there began to emerge a new type of state statute drafted with the proscriptions of the Supreme Court decision clearly in mind, but focused more on traditional corporate law principles than on the mechanics of the tender offer process. An Ohio statute, enacted in November 1982, provided that any

person wishing to acquire what was termed a "control share" of a company's stock (the initial threshold of which was 20%) would have to obtain authorization to do so from a majority of the shareholders, as well as from a majority of the disinterested shareholders, at a special shareholders' meeting called for that purpose. Nearly identical statutes were subsequently enacted in Wisconsin and Minnesota.

A different approach was taken in Maryland, which chose to deal with the unfairness often found in a two-tier acquisition by providing that, once a shareholder had achieved a 10% level of ownership, any business transaction involving the corporation and that 10% shareholder had to be approved by shareholders holding 80% of the corporation's outstanding shares, as well as by two-thirds of all shares excluding the shares held by the interested shareholder. These supermajority vote requirements, however, do not apply if the price paid to the shareholders in the second step of a two-tier transaction is at least equal to the highest price the interested shareholder paid for similar securities in the first-tier acquisition. The Maryland statute was passed in June 1983, and similar laws have subsequently been enacted in a number of other states, including Connecticut, Kentucky, Michigan, Pennsylvania, Wisconsin and Georgia.

The issue of whether these "second-generation" state takeover statutes have successfully avoided the same constitutional debilities as infected the first wave has yet to be definitively resolved, and is an important matter for this Committee to address as it begins its hearings to determine whether any Congressional action on hostile takeovers is appropriate or needed. It is apparent from a perusal of the financial pages that literally hundreds of major companies have, within the last two years, sought and obtained shareholder approval to amend their corporate charters so as to provide for staggered boards and "fair price" provisions, usually with the further provision that a supermajority vote would be needed to rescind or modify the amendment. Less apparent is the fact that proposed legislation similar to that which I have just described has recently been introduced in a number of additional states, including New York. The legislation is reflective of the state's overriding interest in protecting its affected constituencies from the fall-out often associated with a hostile takeover.

When Congress passed the securities laws in the mid-thirties, it expressly stated that it was not preempting the jurisdiction of the state securities commissions, but courts construing the 1968 Williams Act amendments have

frequently concluded that any state legislation which impacts in any way on the tender offer process frustrates the purposes and objectives of Congress in enacting those amendments. It should be emphasized that the U.S. Supreme Court has not reached this conclusion, but several federal appellate courts have. The Congress therefore needs to include in any legislation it might enact a section making it crystal clear that, in adopting the shareholder disclosure and withdrawal rights provisions of the Williams Act, it did not intend to preempt any state law except to the extent that compliance with the state law would make compliance with the Williams Act provisions impossible. This is the approach taken by Senator Proxmire in the last subsection of his proposed "Corporate Productivity Act of 1985" (S. 706), and we favor that approach. It also needs to be made clear that the SEC cannot, simply by utilizing its general rulemaking authority under the proxy provisions of the Williams Act (15 U.S.C. §78n(e)), retroactively create a clear conflict where none has previously existed.*

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* For example, when the SEC adopted the provision of Regulation 14D (17 C.F.R. §240.14d-2(b)) requiring that the terms of a tender offer be disseminated to shareholders within five business days of any public announcement or statement, it deliberately created a direct conflict with the pre-disclosure filing provisions of the various state statutes.

The Proposed New York Legislation

I want to spend just a few minutes outlining the two principal provisions of the proposed New York State legislation, and describing how they would operate.*

The first provision becomes pertinent when an individual acquires 10% of the stock and then proposes to enter into any kind of a business transaction with a corporation. The provision is designed to eliminate the situation where, for example, the 10% shareholder might propose that, in return for some portion of the corporation's assets the value of which would substantially exceed the market value of his shares, he would transfer the shares back to the corporation. Under present state law, the transfer could take place provided it was approved by the board, but the 10% shareholder may control several seats on the board and thus be able to ensure a favorable vote. This is a somewhat more sophisticated form of "greenmail." The proposed legislation deals with this eventuality by providing that any transaction of the type described must be approved by a majority of the disinterested directors of the corporation. If their authorization cannot be

* The legislation described was introduced in the New York State Assembly on March 26, 1985 (A. 6971) and in the Senate on May 8, 1985 (S. 5846).

obtained, the transfer can still go forward, but only if it is approved by a two-thirds vote of the outstanding shares, as well as by a majority vote of the disinterested shares.

The same provision also operates if, for example, a shareholder, whether through a tender offer or otherwise, has acquired a significant percentage (e.g., 55%) of the company's stock and then proposes to acquire the remaining 45% in a second step transaction in which he would merge the corporation into one of his affiliate companies. As long as the controlling shareholder was planning to offer the minority shareholders the same per share price as he had paid to acquire the controlling interest, the proposed New York statute would not come into play, nor would it if a majority of the disinterested directors approved the controlling shareholder's proposal. If neither were the case, then, just as in the illustration above, the transaction could not take place unless it were approved by a two-thirds vote of the outstanding shares, as well as by a majority vote of the disinterested shares.

In essence, whenever a corporation has a shareholder who controls 10% or more of the stock, the proposed statute would give the remaining shareholders a high level of protection against both the self-dealing transaction and the

squeeze-out merger, because, unless the disinterested directors first agreed or a defined fair price was being paid, the transaction could only take place if a majority of the disinterested shareholders had approved it.

The second provision is addressed to the situation where a person is proposing to acquire shares in a New York corporation which would give him a percentage of ownership above any one of three levels, specifically 20%, 34%, or 50%. In those instances, unless the acquiror is prepared to make a cash offer for "any and all" remaining shares (in which case the statute would be unapplicable), the acquisition must be approved by the board of directors, as well as by a majority of the disinterested directors. If the acquisition fails to win both levels of board approval, it cannot go forward unless it is approved by a two-thirds vote of the outstanding shares, as well as a majority vote of the disinterested shareholders (i.e., those who are neither officers nor directors of the corporation, are unaffiliated with the proposed acquiror and were shareholders of record on the day the share acquisition was first proposed).

The purpose of this second provision is to give the shareholders, in those situations in which someone is proposing to acquire a controlling block of stock without authorization

by the disinterested directors, voting rights similar to those which they now exercise regarding transfers of control through merger or asset sales.

It is important to note that neither of the two provisions I have just described would apply to New York corporations unless their shareholders wanted them to. The proposed legislation provides that any corporation can "opt out," either by amending its certificate of incorporation or by adopting a by-law to that effect. In other words, the ultimate authority rests where it should, i.e., with the shareholders.

If the legislation I have just described is adopted -- and The Business Council is actively supporting it in every way possible -- New York State will not be "plowing new ground" but rather reacting, in the same manner as have the legislatures of Connecticut, Georgia, Kentucky, Michigan, Ohio, Wisconsin and an increasing number of other states, to a growing concern that, in the current takeover environment, small investors, long-time employees and local communities have become mere pawns in a high-stakes chess game played by sophisticated, well-financed speculators whose paramount objective is to increase their own personal wealth. Clearly, this is a legitimate area of state concern and for state legislative action, and we submit that this Committee, if it ultimately

recommends any legislation at all, should be mindful of the need to maintain a clear distinction between the federal securities laws and the state corporate codes, and so, in any legislation it does propose, specifically and explicitly reserve to the states their traditional role in matters affecting corporate governance.

Mr. Chairman, Members of the Subcommittee, thank you for the opportunity you have given me to address this very important subject.

Senator PROXMIRE. I'm glad you called that to my attention, and I'll certainly ask the chairman to reread that part which he missed, because I think it is absolutely critical.

I think the testimony here has been superlative, very good, but what's concerned me is the effect of the takeover threat on the policies of management with respect to long term and short term. If there has been any consistent criticism of American business in recent years by the kind of people that most of us respect, it's the vision of managers has been too short term.

Now we're entering a situation now where we may very well lose the investment credits. In fact, that's in almost all the proposals simplifying the Tax Code and is very likely to pass. So we lose that, and of course, that is an enormous incentive for investment in plant and equipment.

You are saying when you invest in plant and equipment and you buy land and you make these other long-term investments, the payoff may be 30-50 years ahead. But you have to look at if you're going to strengthen your operation.

SIGNIFICANCE OF R&D

Let me ask each of you gentlemen about one other thing that has bothered me a great deal in this same connection.

I'll start with Mr. Sigler and go right across.

What effect do takeovers have on the amount and the quality of research and development? Do they tend to discourage research and development, or do you think the effect is not signficant? Mr. Sigler.

Mr. SIGLER. That's been a subject, Senator, that has been used as trying to evaluate the effect of takeovers, whether they are bad or good. I think it's very difficult to say right now. Research and development is a very, very different thing to different industries. Not only what you do, but the amount of your budget that you spend on it, and the kinds of payouts. With many consumer products, things that are called research and development, the payout is quite quick—new and improved.

In our kind of business, it goes along with the longer term aspect that John Georges talked about, and we tended to look at it differently.

I don't think we know. I think within our business, it's almost impossible to respond and do things short term.

Senator PROXMIRE. You see, what I have in mind is the notion that if the management is concerned with the next quarter's profit return, if they're concerned that in defending themselves against takeovers, they've got to show a quick profit, and that many investors may figure whether or not to buy on the basis of the price-earnings ratio, something like R&D for many corporations, at least, is fairly long term. It may not, as you say, be 30 years, but it could be 1 year, 2 years, 3 years, and certainly you don't do R&D and expect it to pay off that quarter.

It would seem to me the threat of takeovers would tend to discourage research and development.

Mr. SIGLER. If you want to take the paper business, I will make a positive statement, yes, there is intense short-term pressure on us to perform, and the takeover phenomenon has intensified that many, manyfold. In some industries, probably R&D is a good measurement. In our industry, international capital investments, those kinds of judgment are the ones that show. And I don't know whether we've got good enough numbers yet to show, but there's no question that those kind of things are under intense pressure.

So from our industry, it's capital investment, not R&D. R&D is minor.

Mr. TROWBRIDGE. If I may, there are really two parts to the answer, Senator. One is the general problem faced by management that is being judged by a financial measurement system which consists of quarter by quarter, very short term comparisons, and therefore, the tendency is always there to defer an investment or research and development program, if by so doing, you might make things look a little bit better by the next reporting period. That's just part of our system of measurement, and it does tend to emphasize short-term decisions for some companies.

I think in a hostile takeover situation which results in a company burdened by an enormous amount of debt, that almost automatically delays and perhaps cancels most of their long-term research and development function, simply because they have to devote such huge amounts of money to repay debt.

The kind of decision that a company operating freely, without a hostile takeover situation, to put money into research and development, is a smart and long-term move that good management will take. It is particularly important that we encourage this by our tax laws and by enhancing our ability in this international competitive world, which John Georges has mentioned, to help the capital-intensive companies survive and, indeed, prosper in a very tough marketplace.

Senator PROXMIRE. Mr. Georges.

Mr. GEORGES. I would agree. If you broaden the terms to include all the long-term kinds of decisions which I think Andy was trying to enumerate—capital forestry research, et cetera. Yes, they're all impacted, when one has to look over his shoulder. I also agree with Sandy when he says it becomes very acute when the guy's at your

door. You perhaps can roll along, as long as you're not a target, but I suspect, as you see the companies that have been impacted and have been approached, and what have you, and see how they have reacted, I would say the threat of a hostile takeover would have a very material impact on how they behave on R&D.

Senator PROXMIRE. My time is just about up.

Let me ask Mr. Trowbridge one question before I recognize Senator Metzenbaum.

The stock of all U.S. corporations is selling for 65 percent of replacement value of company assets compared to about 115 percent in the 1970's.

If this true, why is this so, and why doesn't the stock market behave the way academicians like Bradley and Jensen say?

Mr. TROWBRIDGE. Senator, I'm really not capable of giving you a good answer at this time to that question, but I will respond at a later date. I think the methods by which stocks are evaluated by the financial community vary all over the lot. The influence of inflation, obviously, over that same period of time is part of the answer. But I don't know the answer to your basic question.

[The following information was subsequently submitted for the record:]

National Association
of Manufacturers

ALEXANDER B. TROWBRIDGE
President

JUN 24 PM 3 5

June 21, 1985

The Honorable William Proxmire
United States Senate
Washington, DC 20510

Dear Senator Proxmire:

It was an honor to appear before the Senate Banking Subcommittee on Securities June 6 to testify on behalf of the National Association of Manufacturers on the important issue of hostile takeovers.

Your leadership and efforts have had a major impact on focusing the national debate on hostile takeovers. During the June 6 hearing you raised an important question which I did not feel prepared to address at that time. The question goes to the essence of the issue of hostile takeover activity. I would have responded sooner, but I have been in Europe the past week.

You prefaced your question by stating "The stock of all U.S. corporations is selling for 65 percent of replacement value of company assets compared to 115 percent in the 70's." You then asked why this was so and why the stock market doesn't behave the way academicians like Bradley and Jensen say?

Bradley and Jensen argue that the stock market is an accurate measurement of stock value, and that hostile takeovers are an efficient reallocation of capital. Under such a theory certain companies might be targets for hostile takeovers if the stock market viewed their current production efforts as less valuable than the production efforts of certain other corporate enterprises. This argument has been given before Congressional subcommittee hearings to explain the vulnerability of targeted oil companies to hostile takeovers. But as the preface to your question highlighted, this kind of argument may be too narrow. Undervaluation is a problem not just with select corporations but with our entire industrial base.

What is the reason for this broad undervaluation? I believe the current undervaluation of corporations stems from the fact that from 1968 to 1980 our country experienced high inflation and a decline in real earnings. The assets of corporations have been and still are undervalued because of the anticipated erosion of earning power due to inflation. Mr. John J. Phelan, Chairman and Chief Executive Officer of the New York Stock Exchange stated recently before a Congressional hearing that the low point of this under evaluation was around 1974 or 1975. It was his position before a House Energy and Commerce Subcommittee that anticipated inflation rather than

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"inefficient management" was the cause. The high cost of capital and current adverse trends in our credit markets are also responsible for undervaluation. Henry Kaufman, Vice Chairman of The Phibro-Salomon Inc. and Executive Director of Salomon Brothers recently testified stating that the integrity of our credit market is being "chipped away". He stated four major adverse credit developments: the debts of households, businesses and the government are increasing at an unprecedented pace; the short-term borrowing, mainly floating-rate financing, is rising rapidly while long-term, private sector, fixed rate borrowing has diminished; the credit quality of corporations continues to deteriorate; and the equity base of many financing institutions has grown exceedingly thin. These factors, I believe, have an effect on the stock market's perception of future corporation growth.

Reducing the massive federal deficit will be an important step in improving the quality of credit markets. In the meantime, NAM supports legislative proposals which would extend the time period for tender offers, close the 13d ten day window, lower the threshold limit for filing notices with the SEC and greater disclosure under the Williams Act. Provisions such as these will help insure the long-term health of the economy.

Sincerely,

A. B. Trowbridge

Alexander B. Trowbridge
President
National Association of Manufacturers

Senator PROXMIRE. Mr. Sigler.

Mr. SIGLER. Well, obviously this is an area of opinion, but the shareholders changed dramatically in the last 10 years. We now have the institutional owner. Mr. Goldin works for a for-profit operation. There are precise ground rules of what profit-earning ratios every industry gets, and stocks are priced totally on last quarter's earnings or anticipated this quarter. That's why when IBM or Bank of America says their earnings will be down, in a couple of days you see the stock go down. There are no emotional runups of stock. There is no such thing as an overvalued stock. It's all professional. There are 6,000 very bright people studying the market trying to do better than each other, and it's brought this thing very tightly held. We did not manage the market that way 10 years ago.

Senator PROXMIRE. Thank you.

Senator D'AMATO. Senator Metzenbaum.

Senator METZENBAUM. Mr. Sigler, as you know, the SEC has a study suggesting that takeovers do not discourage long-term investments.

First I would ask you, do you have any comment on the study or any empirical evidence of your own that would lead you to a different conclusion?

Mr. SIGLER. Well, the particular study is the R&D study that Greg Jarrell did, and I think you can make some arguments that if you take two lines of numbers and see they're moving roughly the same, then you can make any opinion you want in the short term.

I think I prefer to cite, generally, my frustration in dealing with that whole list of economists that have attempted to look at this from a macro basis. I think that's the word that they like. I think we are finally getting to the point that the numbers are big enough. I think the $90 billion out of equity last year was the best number we finally had that shows my board, "God, what are we doing to ourselves?" I think the SEC number that I think Sandy quoted of almost 1,500 companies putting in antitakeover provisions, shows the intensity in the involvement. But I don't think we have any great big numbers for the whole economy, because when you think about it, the takeover game is played in a rather small segment of those great big numbers, and there are pluses and minuses of GNP changes for a time after they are announced.

So I don't think we have macronumbers.

I don't look at that study as the best thing we have available.

I think the equity extraction issue is most useful indication from the public interest point of view.

Senator METZENBAUM. The Delaware Supreme Court issued an unbelievable decision that pretty much permits management to do anything to entrench themselves without shareholder approval.

Now regardless of the merits of hostile takeovers, shouldn't the shareholders have a right to approve these kinds of tactics, once a tender offer has begun? Wouldn't it be fair to the shareholder?

Mr. SIGLER. Of course, our suggestion is to eventually go to a deliberate shareholder vote.

Senator METZENBAUM. A what?

Mr SIGLER. To establish a mechanism that gives a deliberate process, a shareholder vote on all of these.

Again, as one of the few nonlawyers here, I think in the simplification of the *Unocal* case that was mentioned here today, that those changes don't mean anything. It made a unique decision on one specific thing which says that you can kill yourself before they kill you. And I don't think that it makes a big difference in the long run.

But our position is that shareholders should be allowed to vote.

Senator METZENBAUM. You would generally feel that shareholders ought to have a right to vote?

Mr. SIGLER. We've got nowhere else to go. That's the control. One of the frightening things is when I hear the largest individual owner of shares saying he wants to sell his votes. We have nowhere else to go for approval. That's the way the system works.

Senator METZENBAUM. It has to go to the shareholder.

Mr. SIGLER. It has to.

Senator METZENBAUM. Mr. Trowbridge, you have indicated that there should be no legislation that would keep target management from defending itself against coercive two-tier offers.

My question is this: If Congress prohibited two tiers, shouldn't the major defensive tactics during the tender offer process require shareholder OK? In other words, you have said we shouldn't do anything to keep management from defending itself. Well, I can't understand that and I must say I'm opposed to the two-tier offer. What concerns me is the actions of some management in taking

whatever action they deem appropriate and really to hell with the shareholders, let's just protect the management. Shouldn't we have something where the management cannot in that period change the rules of the game just to entrench themselves?

Mr. THOMMEN. I think we're seeing a lot of self correcting and preparatory, or let's say precmergency, dealing with this problem, Senator. Many companies, under State laws where they're incorporated and with the shareholder approvals at the annual meeting, through proxy statements, are establishing the rules by which they would deal with a tender offer if confronted with one and are getting shareholder approval of the strategies which they would employ.

In some cases they would ask shareholders to deny them the right to pay greenmail. In others they have established staggered terms for boards of directors which, with shareholder approval, gives a sense of continuity and a sense of some permanence to the management to exercise business judgment rule under conditions where they're not pressured into stampeded decisions.

I think, clearly, shareholders should be treated equally and fairly. Shareholders should be given the right to vote on the basic question of strategy, structure, and long-term survivability of the corporation.

Senator METZENBAUM. So that you would agree that defensive tactics taken during a tender offer pending should be submitted to shareholders for their approval.

Mr. THOMMEN. If they're not already approved under existing shareholder agreements.

Senator METZENBAUM. Well, if they're approved, you don't need it.

Mr. THOMMEN. That's right.

Senator METZENBAUM. Thank you.

Senator D'AMATO. Mr. Georges, before I went down to vote, you were concluding your testimony. You were on the area of States and their legislative prerogatives and attempting to work out some manner in which the Federal Government did not infringe upon the States. If, for example, we were to, on a Federal level, require than any tender offer subject to financing should require a 100-percent firm commitment, would you feel the same way if that flew in the face of the State law that did not require that?

POSSIBLE PREEMPTION OF STATE LAW

Mr. GEORGES. Very definitely there are certain areas in which I think a modification of the Williams Act would be a step forward and we would be for that, and it should apply to everyone. All I'm trying to drive at is you can decide to go at this problem by way of fine tuning the Williams Act, but not necessarily trying to cover the waterfront with new legislation, because the States are also in that field as well.

It would be helpful for Congress to explicitly state that it does not intend to preempt any State law except to the extent that compliance with the State law would make compliance with the Williams Act provisions impossible.

In other words, right now, the way the courts are construing State statutes in light of the Williams Act, you can't do a million things. Well, I don't think that was the intent of Congress when they passed the Williams Act.

Senator D'AMATO. Let's go back to the tender offer subject with respect to financing and with respect to acquisitions.

What would be your feeling—I'm now quoting Mr. Rohatyn's language. He said:

> Anyone making a tender offer should be required to have firm financing commitments in hand for 100 percent of the required capital.

Mr. GEORGES. That's a very strong statement and we would support it. In fact, in the New York legislation that we are proposing, we are saying a cash offer for any and all shares goes directly to the shareholders.

Senator D'AMATO. Well, he didn't say it goes directly to the shareholders. Now, you're moving again.

Mr. GEORGES. I was just saying that as an indication of our support.

Senator D'AMATO. OK. He also indicated that the minimum tender offer period should be extended to 60 days. He didn't say 60 business days; he said 60 days. What do you feel with respect to that?

Mr. GEORGES. I think I mentioned that. Now, 20 is much too short; if you were to offer me 60 versus 20, I'd be way ahead and I think that's a positive step.

Senator D'AMATO. You see, Mr. Georges, what the Senator is attempting to do is to take some of the diversions and most controversial points and seeing if we can't narrow it down so that we can attempt to build a consensus that makes some sense from both the management point and also from the free capital point. So that we're not coming down because the third point I'm going to mention—see, I mentioned two that you agree with. Now, you know, that's too good to be true. We can agree two for two.

But let's look at the third point, and that is point B on page 12. It's the last sentence of Mr. Rohatyn's presentation, and he suggested: "The list companies with various classes of voting securities." In other words, coming back to it another way, indicating that there should be one vote for one share, that there should be that commonality not some of the other.

Now, if in moving in this manner that were to be the thrust of the legislative initiatives as well, and my friend Senator Metzenbaum has left, but he is prepared to introduce a legislative initiative requiring that. What would your feeling be?

Mr. GEORGES. Let me answer that not for the Business Council because I haven't tested them on that but let me answer for myself and I think I would have the support of the Business Council, that that would not pose problems.

Senator D'AMATO. It would not?

Mr. GEORGES. No; we have one share one vote, and I have no present intention of changing that.

Senator D'AMATO. That's provided you want to see some of the other action take place as well; don't you?

Mr. GEORGES. I don't have any problem with one share one vote, so that is not taking anything away.

Senator D'AMATO. Mr. Trowbridge, do you feel the same way?

Mr. TROWBRIDGE. I don't know of too many companies which operate differently and like John I would think this would be an acceptable principle.

Senator D'AMATO. Mr. Sigler.

Mr. SIGLER. The Round Table has no position on the question. I don't think most companies have any objection to that issue standing on its own feet.

Senator D'AMATO. Three for three? That's not bad. I thought we'd only wind up two for three.

Yes, Mr. Sigler.

Mr. SIGLER. I would like to make a comment that I think I skipped over fast.

We came out with proxy versus tender because when we went through how do you deal with disclosure, the proxy is a better mechanism than tender. Tender is today something you print in the paper and you go so many days, and proxy is an establishment for laying out things for shareholders to look at. You don't have to put a time level on proxy. It grinds its way out, as John said, after approval, it usually takes 2 months or so. But it's a mechanism that we all know how to do, and I think it does a better job of disclosure. Tenders were not meant for disclosure.

Senator D'AMATO. Let me thank the panel for your testimony, for your graciousness in bearing with us and the length of the hour and we'll have, as you know, one more hearing.

The fourth and last panel, Kenneth Miller, managing director, Department of Mergers and Acquisitions, Merrill Lynch; Warren Foss, managing director, Salomon Bros.; Ralph Ingersoll, president and chief executive officer, Ingersoll Newspapers.

STATEMENTS OF KENNETH H. MILLER, MANAGING DIRECTOR, DEPARTMENT OF MERGERS AND ACQUISITIONS, MERRILL LYNCH; WARREN M. FOSS, JR., MANAGING DIRECTOR, SALOMON BROS., INC., ACCOMPANIED BY ROGER MILLER, MANAGING DIRECTOR, MERGERS AND ACQUISITIONS, SALOMON BROS., INC.; AND RALPH INGERSOLL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INGERSOLL NEWSPAPERS, INC.

[The complete statements follow:]

TESTIMONY OF KENNETH H. MILLER, MERRILL LYNCH, PIERCE, FENNER & SMITH, BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
JUNE 6, 1985

Chairman D'Amato and members of the Subcommittee, my name is Kenneth Miller and I am the Managing Director in charge of Merrill Lynch's Mergers and Acquisitions Department, in the Strategic Services Group of Merrill Lynch Capital Markets. In that capacity I am principally responsible for the Firm's merger, acquisition, divestiture, corporate advisory, leveraged buyout and strategic advisory services. Prior to becoming Managing Director of Merrill Lynch's M&A Department in 1978, I was a First Vice President in the Mergers Department of White, Weld & Co., where I also specialized in advising companies on corporate combinations. Before that, I had been the manager of Urban National Corporation, a venture capital fund which I founded in 1971 and which specializes in minority investments.

This morning the Subcommittee is considering the important topic of the recent surge in corporate takeover activity in the United States and the advisability of legislation to further regulate the takeover process. Certain developments such as "greenmail" and "poison pills", as well as the complex issues inherent in the question of financing takeover activities, have received a substantial degree of attention in the press, in the Congress and the regulatory agencies and in corporate boardrooms. The Subcommittee is to be commended for conducting

a careful consideration of these matters and I believe that my particular background as a merger and acquisition specialist can bring a different and I hope, helpful, perspective to some of these issues.

Corporate takeover activity has both positive and negative implications. Generally, takeovers are economically desirable because they provide additional liquidity to the nation's equity markets, enable shareholders to realize a premium above the prevailing market value for their shares, and frequently move targets' assets into the hands of more efficient management. Properly structured acquisitions renew and sustain the vitality of our economy and are therefore often in the public interest.

Certain abuses of this otherwise beneficial process, however, are occurring in the takeover arena with increasing frequency. For example, during the past three years instances of "greenmail"--where shareholders threaten to buy up a company and then either force management to buy out their shares at a premium price or sell such shares at a premium in a company self-tender--have risen. Typically, greenmail benefits only the takeover entrepreneur. It diminishes the corporate treasury, adds nothing to the national wealth, and deprives the public shareholders of a premium for their shares--a premium which the prospective hostile bidder alone procures.

Moreover, even in those instances in which corporate management steadfastly refuses to succumb to greenmail and buy back the shares, the "bust-up" artist stands to benefit if he can consummate the hostile tender himself or precipitate the sale of the company to a third party. The result, in either case, often is that the raider is able to force the company to be sold at the wrong time or for less than its optimal value.

Corporate managements are beginning to recognize that greenmail, as an anti-takeover mechanism, does not work. Companies who buy out a substantial stockholder in order to forestall a hostile takeover bid often find themselves "on the block" and being acquired by a third party shortly after the initial buy-out. Moreover, shareholders of some companies who have submitted to such greenmail are currently challenging this practice in the courts, and the courts are evincing a willingnes to deal with these and other perceived takeover abuses on a case by case basis. In other instances, companies are, on their own initiative, taking action to preclude their being subject to the greenmail tactic, by adopting appropriate amendments to their charter and by-law provisions.

The number, and nature, of highly-leveraged acquisitions have also been the subject of recent concern. A new phenomenon is now occurring in the takeover arena, one which perhaps can best be illustrated by the following scenario. An individual, often without giving advance warning, commences a unilateral tender offer for 50% or more of the shares of

blue-chip XYZ Corporation at a substantial premium above market. The consideration for this first step of the takeover is cash, financed in large part by the placement of high-yield, less-than-investment-grade debt securities, commonly referred to as "junk-bonds". Typically, these securities have been placed with institutional investors, who are attracted by the high yield and are presumably capable of analyzing and bearing the financial risk of such an investment.

The bidder announces that he intends, upon the successful completion of the first-step, to engage in a second-step merger to acquire the remaining XYZ shares. However, the second-step merger will not involve a cash payment to the remaining shareholders. Instead, the bidder intends to pay XYZ's remaining shareholders with additional high-yield, less-than-investment-grade debt securities. Generally, the securities issued to the public in the second step are subordinate, in terms of security, timing of principal payments and interest or dividends, to the bonds purchased by the institutional investors in the first step. It is this second-step--the new phenomenom of the public shareholders receiving junk bonds for approximately half their shares in the back-end of the takeover--which raises important questions of public policy, some of which I would like to address today.

Financing a takeover with so-called "junk bonds" can be viewed, from a historical perspective, as a variant on leveraged financing acquisition efforts. The takeover activities in the

late 1960s were financed in large part through the issuance by acquirors of convertible debt securities, convertible preferred stocks, warrants and other forms of hybrid securities that quickly became known as "funny money." Then, in the 1970's and continuing through the '80's, a number of aggressive acquirors consummated deals financed on the basis of their balance sheet, or on the combined strength of their balance sheet and that of the target.

Viewed in this light, junk bonds as an acquisition financing technique may be just a logical development of a trend that dates back many years. The principal difference from this historical context is that bidders in the most recent deals have used the financing techniques developed in the earlier, friendly transactions as a means of raising cash to effect the first, crucial step of a hostile, unilateral bid, and then forced similar, but further subordinated debt on the remaining shareholders to consummate the necessary second-step merger.

The simple question one often hears is whether junk bonds should be used to finance acquisitions at all. This question raises a host of broad, complex issues and often competing concerns of economic policy, credit allocation and banking regulation. We believe that it is not useful to focus on whether junk bond financing should or should not be permitted. Put so broadly, the use of this particular technique, or legislative or regulatory restraints upon its availability,

essentially are issues of macro-economic policy and credit allocation. What I would like to focus on is the narrower and more manageable issue of the impact this acquisition technique has on public investors, particularly in the second step of a unilateral acquisition.

The ability to raise private junk bond financing quickly has permitted a limited group of aggressive acquirers to make unsolicited premium cash offers directly to the target's shareholders. In most cases, however, the offer is only for a portion of the outstanding shares. Thus, as I alluded to earlier when I raised the public shareholder issue, the existence of a first step premium cash offer does not end the inquiry. Many takeovers today are accomplished in a two-step or two-tier process. Whereas the first step may be cash for about 50% of the outstanding shares (albeit junk-bond financed through private placements), the second step or "back-end" of the acquisition often involves an offer by the bidder of some form of subordinated, high-yield securities to those shareholders who have not taken advantage of the premium cash offer in the first step or whose shares were only purchased in part as a result of proration of the oversubscribed first step. This two-tier type of deal structure, in effect, forces the target's shareholders to rush to take the cash in the first step because of the uncertainties represented by the second-step transaction. Moreover, there is the

troubling fact that these second-step junk bonds issued to the public shareholders are usually subordinate to the junk bonds issued to the investors who financed the first step.

Granted, the current panoply of federal and state securities regulations generally require the bidder in such instances to provide detailed disclosures concerning its business, its financial condition, the terms of the securities and the other financing arrangements which are part of the transaction, as well as the effect the transaction is expected to have on the target company. While such a disclosure-oriented system is often of great value and far surpasses that required in other nations, its one possible shortcoming is that it can, on occassion, present the target company shareholder with a "prisoner's dilemma"--that is, notwithstanding full disclosure of the relevant facts and financial terms of an acquisition proposal, the shareholder in the two-tier, junk-bond second-step type of bid has little choice but to tender into the first step (even if such holder has independently concluded, on the basis of all the information provided, that the proposed transaction does not represent the maximum value which might otherwise be obtained for his shares).

In summary, it appears that the tactic of "greenmail" is now being appropriately addressed by potential target company management and shareholders, and in some instances, by the judiciary and the marketplace. Further legislative inquiry may

be warranted, however, in the event that such efforts fail to curb the abuses of this tactic. For example, although there are various legislative alternatives which may be considered to curtail the egregious aspects of this practice, one approach might be to require that an offer to buy back shares from a person holding in excess of a certain threshold percentage of shares (in instances in which such shares have been held for less than a prescribed period of time), at a price above a certain threshold premium to market, must be extended to all shareholders. One drawback to addressing this issue through legislation, however, is the inherent statutory inflexibility which may preclude the ability to deal with each case in light of its particular and possibly mitigating facts and circumstances.

With respect to the issue of so-called junk bonds, I believe that the use of high-yield, less-than-investment-grade debt securities to finance tender offers is part of an evolutionary process of financing takeovers. It should be viewed in that context and caution should be exhibited with respect to legislative and regulatory attempts to impose impediments to such techniques without fully understanding their consequences. In this regard, I think that an outright prohibition or a moratorium on the use of junk bonds in tender offers is both inappropriate and unwarranted at this time. It seems appropriate, however, to urge that further inquiry be directed at the public policy implications of deal structures that utilize even lower quality, high-

yield debt securities in the second step of a two-tier offer. This phenomenon, in my view, does raise serious issues involving shareholder protection, which merit the further consideration of this Subcommittee.

I appreciate the opportunity to appear before the Subcommittee and would be happy to answer any questions from the members of the Subcommittee or its staff at the conclusion of my prepared remarks or in the future.

SUMMARY OF TESTIMONY

OF

WARREN FOSS

MANAGING DIRECTOR, SALOMON BROTHERS, INC.

Mr. Chairman and members of the committee, I appreciate the opportunity to speak before you today. My name is Warren Foss. I am here today with Mr. Roger Miller. We are both Managing Directors of Salomon Brothers, Inc. in New York with responsibilities in several areas including the financing of below investment grade companies, arranging private placements and merger and acquisitions.

Salomon Brothers has watched with great interest ar a fair measure of support as various pieces of legislation have been introduced to curb certain excesses occuring in the "junk" bond financed hostile takeover business, and hope that our presence here will assist you in formulating legislative corrections to various problems that have arisen. However, we also hope that any enacted legislation not throw the proverbial baby out with the bathwater. To that end, we propose certain solutions which we believe would curb various problems while permitting the continued functioning of a vibrant and valued market -- that market for below investment grade securities which is used to finance the ordinary business of a considerable part of corporate America. Salomon Brothers will be submitting to the subcommittee very shortly a complete and expanded version of the comments and recommendations made here this morning.

The recent spate of "junk" bond financed hostile takeovers or proposed takeovers has obviously raised considerable concerns in many corporate boardrooms, among many investors, and in

Congress itself. These concerns center around: 1) the ultimate exposure of the taxpayer to risks incurred by federally insured institutions purchasing these securities and to the overall soundness of our financial institutions; 2) the economic risks of creating heavy debt loads within corporate America; 3) the "loanhouse practice" of greenmail; 4) the support of the tax system for debt financed takeovers with the concomitant loss of tax revenues to the Treasury; 5) societal dislocations caused by hostile takeovers; and so forth. Were it not for the recent flurry of hostile takeover bids financed with mega-issues of junk debt, we doubt that there would be anywhere near the Congressional or other concern with junk bonds that there has been recently. It strikes us, therefore, that curbs should most appropriately be focused in the arena of the currently popular heavily leveraged, junk-bond financed, hostile takeovers which is clearly the area of the greatest problems. We believe that additional curbs are generally not needed.

Additionally, it is important to note that there are many reasons which justify merger and takeover activity. These include such things as reinvigorating management and enhancing shareholder values. As a firm, we feel very strongly that mergers and acquisitions do have a positive effect on our economy.

Let me now turn to some of our responses to various legislative initiatives that impact takeovers and junk bond financing, and to certain solutions to the perceived abuses.

Ingersoll Publications Co.

Memorandum

REMARKS TO UNITED STATES SENATE SUBCOMMITTEE
JUNE 6, 1985

THANK YOU FOR AFFORDING ME AN OPPORTUNITY TO VISIT WITH YOU THIS MORNING. MY NAME IS RALPH INGERSOLL. I AM A CONNECTICUT NATIVE AND THE CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF A NATIONAL NEWSPAPER PUBLISHING COMPANY. WE HAVE 31 PLANTS IN 14 STATES, RUNNING FROM ORANGE AND LOS ANGELES COUNTIES ON THE PACIFIC TO ST. LOUIS ON THE MISSISSIPPI TO THE ATLANTIC COAST OF MASSACHUSETTS. WE PUBLISH 25 DAILY NEWSPAPERS WITH COMBINED PAID CIRCULATIONS EXCEEDING 560,000 AND WEEKLY NEWSPAPERS REACHING AN ADDITIONAL 1,700,000 HOUSEHOLDS -- WHICH TOGETHER GENERATE SALES IN EXCESS OF $200 MILLION ANNUALLY AND EMPLOY APPROXIMATELY 4,000 PEOPLE.

MY PRINCIPAL BUSINESS IS THE ACQUISITION AND REPAIR OF AMERICAN NEWSPAPERS WHICH FOR ONE REASON OR ANOTHER HAVE BEEN INJURED BY CHANGED MARKET CONDITIONS OR MISMANAGEMENT. IN ADDITION, WE FREQUENTLY CREATE NEW NEWSPAPER EDITIONS AND EVEN ENTIRELY NEW PUBLICATIONS.

I AM PLEASED TO HAVE BEEN ASKED TO VISIT TODAY, ALBEIT NOT IN MY CAPACITY AS A PUBLISHER. (EACH OF YOU WHO HAS WON ELECTIVE OFFICE HEARS PLENTY AS IT IS FROM YOUR LOCAL PUBLISHERS!) RATHER, I WOULD LIKE TO SPEAK ON BEHALF OF A

SPECIAL INTEREST GROUP, IF YOU WILL -- ON BEHALF OF SMALL AND MEDIUM SIZED COMPANIES, SUCH AS MY OWN, WHICH HAVE CREATED JOBS IN THIS COUNTRY IN THE PAST DECADE SUBSTANTIALLY FASTER THAN THE OLD-LINE INDUSTRIAL COMPANIES HAVE MANAGED TO LOSE THEM.

COMPANIES LIKE MY OWN WOULD BE SERIOUSLY HAMPERED IN OUR DEVELOPMENT WERE WE NOT ABLE TO TAKE ADVANTAGE OF A WIDE RANGE OF NEW SECURITIES WHICH HAVE BECOME AVAILABLE IN THE RESOURCEFUL FINANCIAL MARKETS.

MY PRESENT CONCERN IS THAT OTHER INTEREST GROUPS ARE ATTEMPTING TO MISLEAD YOU BY DIVERTING YOUR ATTENTION TO SPURIOUS ISSUES. THIS IS PARTICULARLY TRUE WITH RESPECT TO SO-CALLED "JUNK BONDS." I ABHOR THAT PARTICULAR PEJORATIVE FOR HIGH YIELD SECURITIES, WHICH HAVE ALSO BEEN TAGGED "TAKEOVER SECURITIES" -- WHATEVER THAT MEANS. I ABHOR THE "JUNK" PEJORATIVE FOR TWO REASONS:

1) BECAUSE IT IMPLIES THAT MY COMPANY'S DEBT SECURITIES ARE "JUNK" -- WHEN, IN FACT, MY COMPANY'S TRACK RECORD AND CREDIT ARE SO GOOD THAT I HAVE BEEN ABLE TO BORROW MORE THAN $50 MILLION FROM A MAJOR NEW YORK BANK ON AN UNSECURED BASIS AT THE PRIME RATE; AND

2) BECAUSE THE HIGH YIELD BOND MARKET PLAYS A WHOLESOME AND NECESSARY ROLE IN THE CAPITALIZATION OF SMALL AND MEDIUM

SIZED GROWTH COMPANIES LIKE OUR OWN. SPECIFICALLY, WHAT SENATOR DOMENICI'S BILL CALLS "JUNK" SECURITIES -- THOSE SECURITIES CONSTITUTE IN REALITY THE ONLY PRACTICAL SOURCE OF FIXED RATE, LONG-TERM CREDIT AVAILABLE TO FIRMS WHICH HAVEN'T BEEN AROUND ENOUGH DECADES TO QUALIFY FOR A SO-CALLED INVESTMENT GRADE RATING.

OF COURSE, OTHER INTEREST GROUPS WILL PLEAD THEIR OWN CASES. FOR INSTANCE, BUSINESSMEN WHO RUN THE LARGEST COMPANIES NATURALLY DON'T LIKE BEING ACQUIRED BY SMALLER COMPANIES. AND THOSE PARTICULAR BUSINESSMEN NOW WANT THE UNITED STATES GOVERNMENT TO PROTECT THEM FROM FORCES FROM WHICH THE OPEN MARKET IS PLAINLY UNWILLING TO PROTECT THEM ... ALTHOUGH I HAVE OBSERVED THAT IN OTHER SEASONS AND ON OTHER ISSUES THESE SAME BUSINESS LEADERS ARE RESOLUTE IN THEIR INSISTENCE THAT THE GOVERNMENT NOT REGULATE THEIR UNIVERSE.

NOW I'D LIKE TO SUGGEST THAT YOU BE EXTRAORDINARILY CIRCUMSPECT IF YOU CHOOSE TO PROCEED WITH ANY LEGISLATION ON SECURITIES ISSUES -- LEST YOU THROW THE PROVERBIAL BABY OUT WITH THE BATH WATER. AND WITH RESPECT TO HIGH YIELD BONDS THERE IS A SPECIAL DANGER:

YOU SEE, THERE ARE AT LEAST 18,000 SUBSTANTIAL CORPORATIONS IN OUR COUNTRY -- THAT IS, COMPANIES WHICH HAVE ASSETS OF MORE THAN $25 MILLION. BUT FEWER THAN 700 OF THEM CAN QUALIFY FOR AN INVESTMENT GRADE RATING FROM ONE OF THE TWO

MAJOR RATING AGENCIES. HOW THAT NUTTY REALITY CAME TO PASS MIGHT BE THE SUBJECT OF ANOTHER DAY'S HEARINGS -- BUT THAT'S THE WAY IT IS FOR NOW. THE RATING AGENCIES HAVE ANTIQUATED PROCEDURES WHICH GIVE INVESTMENT GRADE RATINGS TO BIG BANKS, BIG STEEL COMPANIES AND OTHER BIG MANUFACTURERS WHICH SURPRISINGLY FREQUENTLY TURN IN CRITICALLY DISAPPOINTING RESULTS.

ON THE OTHER HAND, THESE SAME CREDIT AGENCIES DENY INVESTMENT GRADE CREDIT RATINGS TO SMALLER COMPANIES WHICH ARE EMINENTLY CREDIT WORTHY AND GROWING -- APPARENTLY BECAUSE THESE LITTLE COMPANIES DON'T HAVE LONG HISTORIES AND LOTS OF FIXED ASSETS ... EVEN THOUGH THEY PLAINLY HAVE BRIGHTER FUTURES THAN MANY OF THE BIG COMPANIES!

SO THAT SITUATION FORCES SMALL COMPANIES TO DEPEND BY AND LARGE ON THE COMMERCIAL BANKS FOR CREDIT. BUT THE PROBLEM WITH THE COMMERCIAL BANKS IS THAT THEIR BUSINESS IS SHORT-TERM LOANS (TYPICALLY FIVE YEARS) AND THEN ONLY AT FLOATING RATES. SO WHAT WE'RE FACED WITH IS TRYING TO BUILD SOLID BUSINESSES WITH SHORT-TERM MONEY THE COST OF WHICH IS UNPREDICTABLE. THAT'S NOT A WHOLESOME WAY TO BUILD A BUSINESS. RATHER, OVER THE PAST 80 YEARS THIS COUNTRY'S VENERABLE COMPANIES WERE BUILT ON ACCESS TO LONG-TERM CREDIT AT PREDICTABLE RATES.

TODAY, THE CORPORATE HIGH YIELD BOND MARKET IS THE PRINCIPAL

SOURCE OF FIXED RATE, LONG-TERM LOANS TO THE SMALL COMPANIES WHICH ARE CREATING VIRTUALLY ALL THE NET NEW EMPLOYMENT IN OUR COUNTRY AND WHICH ARE THE ENVY OF EVERY WESTERN DEMOCRACY. I IMPLORE YOU TO KEEP YOUR EYES ON THAT BALL AND NOT TO ENACT LEGISLATION WHICH WOULD DISABLE SUCH A REMARKABLE NATIONAL ASSET.

I, OF COURSE, AM NOT AN AUTHORITY ON PUBLIC SECURITIES MARKETS, THOUGH I UNDERSTAND THAT SOME OF THE MEASURES YOU ARE CONSIDERING MIGHT ADDRESS CERTAIN PERCEIVED ABUSES IN THE PUBLIC MARKETS. FOR EXAMPLE, MY OWN ATTORNEY, MARTIN LIPTON, HAS ACQUAINTED ME WITH THE PROBLEMS ASSOCIATED WITH TWO-TIER TENDER OFFERS.

ON THE OTHER HAND, THE DOMENICI BILL'S PROPOSAL TO BAN PURCHASES OF HIGH YIELD BONDS BY SAVINGS AND LOAN ASSOCIATIONS STRIKES ME AS BEING EXTRAORDINARILY ILL-CONCEIVED.

MY OWN BUSINESS DEPENDS IMPORTANTLY ON REAL ESTATE CLASSIFIED ADVERTISING, SO I AM NOT UNFAMILIAR WITH THE PROBLEMS EXPERIENCED BY THE SAVINGS AND LOAN ASSOCIATIONS IN RECENT YEARS. S & LS PLAY A VERY SIGNIFICANT ROLE IN UNDERWRITING HOMES FOR OUR SUBSCRIBERS AND, INDIRECTLY, ADVERTISING REVENUES FOR OUR NEWSPAPERS. SO I NATURALLY BELIEVE WE SHOULD BE DOING EVERYTHING POSSIBLE TO STRENGTHEN SAVINGS AND LOAN ASSOCIATIONS.

As you know, the Garn - St. Germain bill tried to help the S & Ls by affording them alternative investment opportunities. New investment opportunities were needed because many S & Ls had lent long-term at low fixed rates but then had to borrow short-term from savers at high rates.

Unhappily, certain S & Ls squandered their new opportunities. They speculated in the unregulated government securities markets and sometimes lost their entire net worth -- usually due to fraud, as in Maryland and Ohio. Others speculated in real estate for their own account -- acting as equity investors rather than as the lenders they were trained to be. Nor have commercial loans worked out too well for S & Ls, because their choice of deals is frequently limited to those no commercial bank would take. Perhaps the Federal Home Loan Bank Board will yet be able to enact guidelines to insure diversification and limitation of net worth exposure per loan.

On the other hand, a few federal savings and loan associations have discovered the safety and earnings advantages of having up to 10% of their assets invested in a diversified portfolio of high yield securities. For a publicly-traded high yield bond is a securitized commercial loan. And, importantly, it is a commercial loan on which 10 or more other lenders have made independent credit judgements -- so no high roller can bedazzle a lone lending officer.

NOW, SINCE HIGH YIELD BONDS SEEM TO REPRESENT VIRTUALLY THE ONLY SAFE, HIGH RETURN, ALTERNATIVE INVESTMENT AN S & L CAN MAKE, IT SEEMS INCREDIBLE THE UNITED STATES SENATE SHOULD BE CONSIDERING LEGISLATION WHICH WOULD ARBITRARILY DEPRIVE THESE INSTITUTIONS OF AN OPPORTUNITY TO RECOVER THEIR HEALTH AND TO ATTRACT THE NEW INVESTMENT CAPITAL WHICH WOULD KEEP THEM WELL INTO THE NEXT CENTURY.

OF COURSE, IT SEEMS TO ME THAT THE REAL MOTIVE BEHIND SUCH A DESTRUCTIVE PROPOSAL IS TO CRIPPLE THE HIGH YIELD BOND MARKET, EVEN THOUGH SAVINGS AND LOAN ASSOCIATIONS ARE JUST MINOR INVESTORS IN THAT MARKET. BUT THE IDEA IS THAT IF THE GOVERNMENT COULD DENY SUCH BOND INVESTMENTS TO S & LS, WHY NOT DENY THEM TO INSURANCE COMPANIES AND PENSION FUNDS AS WELL?

AND ALL THIS NOT BECAUSE HIGH YIELD CORPORATE BONDS ARE DANGEROUS INVESTMENTS. BUT BECAUSE OF SOME FLAP OVER THE FINANCING OF HOSTILE OIL COMPANY TAKEOVERS! IT'S NUTS. ALL THAT WOULD HAPPEN IS THAT THE GOVERNMENT WOULD SUCCEED IN DENYING SAVINGS AND LOAN ASSOCIATIONS A SAFE ROUTE TO RECOVERY AND DIMINISH THE MAJOR MARKET FOR FIXED RATE, LONG-TERM CREDIT AVAILABLE TO THE SMALL AND MEDIUM SIZED COMPANIES WHICH WE PROFESS AS A NATION TO WANT TO ENCOURAGE.

THANK YOU FOR AFFORDING ME AN OPPORTUNITY TO SHARE THESE VIEWS AND CONCERNS. IF YOU HAVE QUESTIONS, I'LL DO MY BEST WITH THEM.

Senator D'AMATO. Why don't we start off with you, Mr. Foss? Mr. Foss, let me ask you if you wouldn't summarize your testimony, as the hour is growing late. We will take it as if read in its entirety, and if you could attempt to make the highlights of your prepared testimony.

Mr. Foss. Sure.

Senator D'AMATO. Thank you.

Mr. Foss. Salomon Bros. has watched with great interest and, in fact, a number of pieces of legislation have been introduced to deal with the junk bond area, and hostile takeover, and what have you, and as we watch those, in fact, we have given a very large degree of support to most of those initiatives, and we think that the concerns raised are obviously very appropriate ones in most cases.

I think it's important to note, however, that were it not for the very visible hostile takeovers, where raiders are on the other side versus the target companies, I doubt that very many of us would be sitting here today. I don't think the intention was to go after the high-yield security business per se, the below grade investment securities business per se.

I think it is very useful to focus our thoughts, in a sense that most of the abuses that we perceive do, in fact, happen inside the hostile takeover business.

That leaves, of course, the thought that there are two, in fact, high yield markets. There is that takeover market and then there is, in fact, the market where regular old companies are raising money day to day to refinance debt outstanding, buy plant equipment, finance inventories and what have you.

PROBLEM OF EXTREME LEVERAGE

The problems that I think we see are the extreme leverage, and we think the prudent lending standards have, in some degrees, gone totally out the window.

We think that these very aggressively financed takeovers are occurring at a time when default statistics are moving up. We do our own default statistics. In fact, as we sell securities to the marketplace, we study it very actively, and I think that there is clearly a case to be made that the historical statistics do not, in fact, parallel the potential risks that one is seeing in the market today.

To make a point on that, yesterday morning, our executive director, Henry Kaufman, who is also vice chairman of our parent company, was testifying before the Committee on Energy and Commerce, the Subcommittee on Telecommunications in the House of Representatives, and I'll only read a paragraph, if I may, Senator. I think it is a useful overview. He says:

> One of the most crucial economic issues confronting our Nation today is the integrity of our financial system. Without financial institutions, practices reflect the judicious balancing of market ambitions and public responsibility. None of our key economic aspirations result in the attainable. Economic growth and its attendant benefits of higher standards of living are eventually arrested when a criticism is abused. Savings and investment patterns are disrupted and distorted; moreover, in the extreme, the undermining of credit could lead to disastrous consequences of political upheaval to the far right or far left and result in economic democracy malfunctions.

It makes the point that the integrity of credit is being chipped away by a financial revolution that is contributing to the lowering

of credit standards and meeting the responsibilities of creditors and debtors. Few, if any, developments are encouraging confidence in the credit structure today.

That is the overview position we, as a firm, take, as in fact, we testified before you today.

The second point that we are troubled about is that in additional to financial risks created, we are sacrificing needed business investment going forward. Now we can talk all about the theoretical studies and what have you, but a number of us who are down here today, and I know myself and my colleague, Roger Miller, to my left, have, in fact, participated in the structuring of different buyouts, and of course, one of the things you're always interested in is maintaining interest coverage.

So if you don't have a very adequate interest coverage number today, you look for where the points of flexibility are to cut it, if, in fact, the deal is to be financed, that is, if you're participating on the financing end of the deal or if you're evaluating the financial structure. We are an adviser to a target company, and I must tell you that, in fact, you look at all the discretionary sources of spending you can find, and again, with the academic studies perhaps being inconclusive, nevertheless, the real world is that there are risks, in terms of immediate business investment going forward.

Third, we think the hostile takeover groups detract significantly from the basis of the management tasks of running a business.

Fourth, we think the community disruptions are significant.

Fifth, we think due diligence standards on the part of underwriters are exceptionally weak in some cases.

Sixth, we think the playing field for the raiders also does not seem even. In that case, we are really talking about the margin rules where you and I, as individuals, can only borrow 50 percent on a stock position, but the fact others manage through various techniques to get that up to 100 percent.

Senator D'AMATO. Let me go back to a question you heard me ask, the last question I asked Mr. Georges with respect to that suggestion put forth by Mr. Rohatyn.

100 PERCENT FINANCING

What would your feeling be then, if there was that requirement that there be a financing commitment in hand, as opposed to the advertising of the best effort to raise the necessary funds—100 percent?

Mr. Foss. Go ahead, Roger.

Mr. ROGER MILLER. My name is Roger Miller. I am a colleague of Warren, and I am in the merger and acquisition group at Salomon's.

Senator D'AMATO. You're Mr. Miller and you're Mr. Miller. Two Millers.

Mr. ROGER MILLER. We have worked on deals together, but we are not related.

I think that that is a sine quo non of continuing an orderly market in takeovers.

Senator D'AMATO. Then you approve that?

Mr. ROGER MILLER. Yes.

Senator D'AMATO. Would that deal with the deficiencies that Mr. Foss just indicated he believes exist?

Mr. ROGER MILLER. No; I don't think it addresses the margin question.

Senator D'AMATO. Well, now, when we raised the question of the requirement of 100 percent financing and, then, in addition, we suggested that there be a marginal requirement, so far today, including Mr. Rohatyn, everyone indicated they did not feel that would be necessary; that, indeed, if there was that commitment at hand of 100 percent of the capital, that that would suffice.

Mr. ROGER MILLER. I think it really is different, qualitatively. If you look at the way the margin rules were imposed, the margin rules came about because of the excessive speculation of the 1920's. They were designed by the wise hand of Government perhaps to save us from ourselves. Coming from a basic believer in the free market system and the desires of an even playing field, that may sound somewhat anachronistic, but when a single purpose corporation does nothing more than raise money to buy stock, I don't see why the same margin rules, in principle, should not be applied.

Mr. Foss. I think there is a broader issue, if I can expand on that, Senator, and I think, to use a name, if Exxon were to go out and acquire somebody, I don't think the people are materially concerned about a credit degradation within America. I hate to put them in a comparative advantage because of their size and existing credit quality.

Senator D'AMATO. Take Exxon just for a moment and put them in that situation, where they were attempting to acquire.

If you were to place that requirement on the merger and acquisition of 25 or 50 percent margin, wouldn't that place them at a competitive disadvantage, as it relates to, let's say, corporations outside of America? Haven't we seen that already—corporations from Canada were coming in to buy assets here?

Mr. Foss. The answer is, there is a disadvantage in the circumstances. The point that I think I was trying to make is a little bit different one.

Senator D'AMATO. I know that. But to answer my question.

Mr. Foss. Yes, sir, there is a disadvantage.

Senator D'AMATO. Well, what purpose is served? Why would you require Exxon then to have—using Exxon and not the kind of situation you pointed out of a company that Shell has maybe put together for the purposes of acquisitions, wouldn't you really be impeding the capital marketplace by doing that?

Mr. Foss. No; I don't think in that case that is the point at all. I think that what we're looking at is that someone like an Exxon, going to the marketplace, to the extent they wish to acquire someone, has, in fact, adequate financial resources to stand on its own, and if they're wrong, and an acquisition, their shareholders will bear some of the cost of going forward; maybe the credit quality will be slightly degraded, but it's not going to be a material degradation.

It's an entirely different world, I think, when you're looking at a situation where corporate America is materially levering up. That is our view, and our credit statistics, as we look at them, and our

numbers are not that $90 billion of equity was retired last year, but rather $102 billion of equity was retired last year.

When you put that macro situation forward, then, in fact, allow 100 percent financing effectively, to go out there and acquire a company, you are ending up with a significantly degraded credit company and risk to the financial system of the country.

That we do not support, and I think the rule or the role that margin plays in that type of situation is one where, for those situations where there's not adequate credit support, that's a very important differential that, in fact, you have created some theoretical event to leverage in a situation by requiring equity in capital to be put in place.

Senator D'AMATO. How much equity capital?

Mr. Foss. Well, it's existing 50 percent for you and I, and I have no idea if that is good or bad, but the Federal Reserve seems to think that is OK for you and I.

Senator D'AMATO. Well, to create a prudent hedge against the loss where that might not be, and you might state that is what is for individuals, but in this area where there has been no margin, do you really think 50 percent would be the answer?

Mr. ROGER MILLER. Well, I don't see why the moneys couldn't be raised on other assets. What we are objecting to here is to a single purpose corporation that is borrowing all the money, based on the security of the stock to be purchased.

UTILIZATION OF JUNK BONDS

Senator D'AMATO. Let me ask Mr. Ingersoll, if I might a person who has been an issuer of high-yield corporate bonds, what is your opinion with respect to this whole area surrounding so-called junk bonds and their utilization in the market? What are you concerned about?

Mr. INGERSOLL. You're speaking specifically with respect to the leverage issue?

Senator D'AMATO. If you'd like to address the leverage issue.

Mr. INGERSOLL. Well, I couldn't disagree more with these gentlemen on that subject. I don't think there's anything wrong in principle with even 1 percent debt to acquire a company. I don't happen to acquire them that way, but there is nothing wrong with that. It's supportable, depending on what you pay for the assets. There are situations in my business—I was short in an auction earlier this year which the Dow Jones Company commenced for the Des Moines Register and Tribune, a company which was ultimately broken up by First Boston, and the First Boston, as do many of these New York investment companies, created a situation in which a price was paid for the Des Moines Register that was so high that if you had 90-percent equity and 10-percent debt, it was insupportable. It was overleveraged at 90-percent equity.

I have bought newspapers over the last 15 years in which I was able to put down 10 percent and comfortably support 90-percent debt with a cash flow from the company.

So I think the notion of proposing legislation that would regulate leverage in some fashion is just patent nonsense.

Senator D'AMATO. Mr. Kenneth Miller, what is your comment?

Mr. KENNETH MILLER. You want my comment on this particular issue?

Senator D'AMATO. On this or you can summarize without reading all of your statement.

Mr. KENNETH MILLER. I would like to say if I may just distill the essence of Merrill Lynch's concern about the takeover phenomenon, our focus is not so much the macroeconomic credit aspect of it but what's going on as far as the public shareholders are concerned. I should say that while we function on all sides of these struggles and we're a big factor in junk bonds, probably a leader in LBO's and we advise on mergers, that the reality is the big risk to the public shareholders, what we call the prisoner's dilemma. He may not want to sell his one share, but if he doesn't he risks being left in a situation where control has passed and everybody else has been paid while he hasn't.

Senator D'AMATO. You're referring specifically to the two-tier offer?

Mr. KENNETH MILLER. Yes.

Senator D'AMATO. I wonder if I could do something unusual and I'll ask unanimous consent of the committee to agree with this. He's looking around to see if I really flipped my lid. How about getting another chair up there and asking Mr. Joseph to come back up on the hot seat.

Come on up here, Fred.

[Whereupon, Frederick H. Joseph, vice chairman of the board and chief executive officer, Drexel Burnham Lambert, Inc. joins the panel.]

Senator D'AMATO. Address the two-tier if you might, what you feel is fair and unfair about it and then I'd like you, Fred—I don't know what your position is—I'd like you to comment on what your feeling on this might be.

SO-CALLED PRISONERS DILEMMA

Mr. KENNETH MILLER. I was just going to go on. I think it's appropriate Mr. Joseph came back because I was just about to say why the two-tier offer presents this problem of what we call the prisoner's dilemma, it's even more exacerbated in a junk bond offer.

In the Gulf matter, for example, where we functioned as adviser to Gulf, we saw for the first time something that many of us had been talking about as a possibility actually occur, where we had to advise Gulf that there was a very real possibility that Boone Pickens in this instance could raise enough capital to acquire sufficient shares which, when added to those he already owned, would mean he had over 50 percent of the company, which was bad enough, but the next step was going to be that the public shareholders would get even worse junk at the back end in a so-called cram down situation, so that first there was the junk issue to acquire control and then the second step would be subordinated paper that the public would be forced to accept at the back end.

Now, in a friendly deal the board can protect shareholders and decide whether the full package is——

Senator D'AMATO. Could I ask you just to suspend for a moment. I have the Attorney General's Office on the phone and I certainly would like to speak to them.

[Pause.]

Senator D'AMATO. OK.

Mr. KENNETH MILLER. Just to finish up, I just want to make sure that the committee understands what we mean by prisoner's dilemma. It is the threat that one is going to be dumped into an inadequately described back or a back end which represents inferior value and inferior quality of security, and it's very difficult for the individual shareholder to protect himself against that two-tier offer particularly in a junk bond context.

It does at least raise the specter of a significant unfairness to the public and that's what we're talking about.

Senator D'AMATO. You would deal with that by eliminating the two-tier?

Mr. KENNETH MILLER. Well, I wouldn't just outlaw two-tier. I'm not here to write legislation but——

Senator D'AMATO. No, no, wait. Wait now. When we receive the suggestions you have made, I don't take it lightly. What I'm saying in essence is as you describe what might be a problem, then let me ask you to drop the other shoe and tell me how you deal with that.

Mr. KENNETH MILLER. Well, I think that is the essence of the free economy that if you own property you ought to be able to sell it and you ought to be able to leverage it and make decisions about it, so we favor an approach that involves the least amount of regulation, that nevertheless solves the problem of this abuse.

One thought that has a good deal of appeal from our point of view is to make sure that where the form of consideration being offered for a company is other than either all cash or all securities, that is, the partial two-tier offer, that we find a way to make sure that the exchange occurs contemporaneously.

In other words, maybe the Congress will put exchange offers involving securities on the same basis as cash offers. And that instance you might have a part cash, part securities offer, but the public could in effect be getting a unit all at the same time. Alternatively, there could be a shareholder vote in the event the company is not being protected by its board in a friendly transaction, somebody wants to offer the two forms of securities, a way to address this would be to say, OK, but then let's submit it to the shareholders so that everybody at a given point in time either votes for it and gets the same thing, perhaps a unit, perhaps a choice—an election-type procedure—or the deal is voted down. But you don't have a situation where the professionals are getting the higher all cash values and the unsophisticated hangers back are getting inferior treatment.

Senator D'AMATO. Fred.

Mr. JOSEPH. I think we're talking about two separate things. With respect to front-end loaded two-tier offers where the back end is lower, I think I agree with Ken Miller. That is not good for the security markets; it's not good for the public shareholders.

I think however that there are other ways of dealing with the unfairness or perceived unfairness, potential unfairness, and I think I'd recommend allowing there to be two-tier takeovers. I

want to go back and talk about why there ought to be two-tier in a moment. But insist that the back end be of equal value with the front end. There's a lot of ways to deal with it.

I'm sure all the investment bankers at the table could define five ways to have a market mechanism to ensure equal value. The reason I believe there's a need for a two-tier—to allow the two-tier structure to exist is that unfortunately on average Drexel's clients are not as rich as Salomon Brothers clients—our corporate clients—and we need access to leverage potential and we need some flexibility in structuring the takeover.

Senator D'AMATO. They're smiling at that statement?

Mr. JOSEPH. That's just because I'm envious and I'd like to have some of the large, wealthy clients.

Senator D'AMATO. No; the Miller's and the Foster's were smiling.

Mr. JOSEPH. I think inherent in a lot of the suggestions you received today, a reference to make it tougher for small companies to do something than a bigger company, make them live with module rules that were never designed to be part of the acquisition or takeover process. They were designed to prevent speculation and acquisition of corporations by other corporations even where the financial vehicle is nonsecurity speculation. It's a form of corporate acquisition.

TWO-TIERS NEED TO BE OF EQUAL VALUE

I think we need to allow there to be flexibility in a way you structure takeovers so you don't build into the rules situations where only the large companies can take over the small companies and I think the smaller buyers, smaller acquirers, need the flexibility of two-tier structures, but I agree with the concept that to be fair to the shareholders, two tiers ought to be of equal value.

Senator D'AMATO. Any other comment?

Mr. Foss. I'd like to make a comment on that. In concept, there should be no problem with that. I mean small companies should have rights to do certain things. There should be, I think broadly speaking, some overall concern about credit quality within this country. I think if we don't do it, Felix's words earlier about financial insanity come right to the fore.

The second thing is that there's a lot of nice commentary about sort of reinvigorating management, and forcing them to do all sorts of things they should have been doing all along, but a lot of those are self-serving comments by a small group of raiders and it's quite interesting to sit down and break down, in fact, where the sources of money are coming from on some of these transactions and find out that these are not poor, underprivileged corporations but rather they're raider groups or pockets of money, in fact, individuals getting together and what have. It's not a disadvantaged corporation.

So I think that there has to be a large measure of evaluation of different comments about fairness and unfairness and who's doing what to whom.

I think it's easy to masquerade in the area; it's a little harder to get through all the facts.

Senator D'AMATO. Mr. Ingersoll.

Mr. INGERSOLL. Well, obviously I'm here speaking not on behalf of the securities industry. There's been a lot of talk today about management in one corner and shareholders in another. I appear to be the only witness here today who is both. I manage, as you know, a group of newspapers. We have 31 plants in 14 States and employ 4,000-odd people. I am both a controlling stockholder and the operator. I think it's pretty plain that all of this discussion has been occasioned by a flap over a few oil industry takeovers—hostile takeovers—and that in the main it has very little to do with what the high-yield market is about.

But would it serve your purposes to wait for my formal remarks or would you like that incorporated off the cuff?

Senator D'AMATO. I'd like it off the cuff.

Mr. INGERSOLL. You'd like to go off the cuff. OK.

The problem here, I think, is that we're overlooking—let me state it this way. I'm here representing if you will a special-interest group. I'm here on behalf of small or medium-sized companies such as my own which have created jobs in this country in the past decade at a rate which is substantially faster than the old-line industrial companies have managed to lose jobs. Those are just facts.

Companies like my own which have created these jobs and the new employment opportunities and which are continuing to grow, would be seriously hampered in our development if we were not able to take advantage of a wide range of the new securities which have become available in this remarkably resourceful financial market.

My present concern frankly is that the interest groups which are testifying here in addition are trying to divert your attention to scurrilous issues.

This is particularly true with respect to so-called junk bonds and I appreciate earlier objection of that perjorative. It bothers me as an operator because for one thing it classifies my company and my securities as junk when before I ever issued a high-yield security I was able to borrow over $50 million, unsecured, at the prime rate from a major New York bank. I won the right to do that by my track record and by the credit worthiness of our company.

Second, it bothers me because I genuinely believe, Senator, that high-yield securities play a wholesome role in the growth of companies like our own and that they, in fact, constitute the only practical source of fixed-rate, long-term credit available to firms which haven't been around long enough to have established credit ratings.

Now, it turns out that there was a lot of talk today about leverage and the precarious state of the financial system. Well, when my father was in business in the 1950's they could pay 5¼, 5⅛ percent for a bank loan and they could get the money for 10 years and the rate was fixed. What's dangerous in a recession in this country is that the dependence of small companies like my own on floating rate, short-term loans from commercial banks.

HIGH-YIELD MARKET CREATES STABILITY

In fact, what has been made possible by the development of the new issue high-yield market is the possibility that we will become

more stable, not less stable. Instead of having to borrow or floating unpredictable costs from commercial banks for 5-year terms, I can now borrow at fixed rates for 15 years. I am inherently more stable because I can do that.

I am concerned that as the other special interests address themselves to these issues that you may, in trying to echo their request, throw the baby out, as someone said earlier, with the bath water.

The credit agencies are behind the curve. I don't know why, how this developed precisely. It's a subject of another day's hearings perhaps. But when there are more than 18,000 companies in this country which are substantial companies, companies with more than $25 million in assets and fewer than 700 of them can get investment grade credit rating, and all the new jobs and all the things that the Congress of the United States supports are created by the one that can't get a credit rating—and we're talking about hobbling or crippling of the market that makes this possible. It just doesn't make any sense to me.

Senator D'AMATO. You did hear the testimony from—I don't know—it may have been Mr. Joseph. Yes; it was—that indicated that as a result of this disparity between what the credit rating does and what the yields are comes an opportunity—an economic opportunity which has been taken advantage of. Isn't that basically what you testified to?

Mr. JOSEPH. Yes.

Senator D'AMATO. So——

Mr. INGERSOLL. Well, I like to speak to just one of the spurious issues which I believe these other groups have tried to draw to you.

Senator D'AMATO. You've got 2 minutes. Then we're going to recess this hearing until June 12 at 9:30, at which time, if any of you wish to return, you will be invited and I will not put you on the last panel. [Laughter.]

Mr. INGERSOLL. All right.

The Domenici bill and other pieces of legislation which have been introduced are trying to draw the Congress' attention to the investment by savings and loan associations and high-yield securities. As most of the people who are talking about this know perfectly well, an extremely small percentage of high-yield securities are owned by savings and loan associations.

I can't fit in 2 minutes why that's an appropriate investment, but let me just suggest to you that there are substantial reasons—good reasons—why savings and loan associations and others should own diversified portfolios of these types of securities.

Frankly, I believe that the reason that they're tossing out this decoy for you is that they believe that if they can persuade you to bend savings and loan associations which own less than 10 percent of the securities to begin with, if they can bend them from promoting them, then they can move onto pension funds and insurance companies and if you legislate against pension funds and insurance companies and savings and loan associations you will, in fact, destroy the high-yield bond market and you will in the process destroy the only source of fixed-rate, long-term capital which is available to companies like my own which have created all the new work, all the new ideas, and all the new products.

Senator D'AMATO. Mr. Ingersoll, on that note we're going to conclude because we have come to the time. We started at 9 and which the exception of a few minutes we have been here until 3 minutes to 2.

I'm going to thank all of those who participated and particularly the fourth panel who has waited so patiently. I'm also going to avail you the opportunity of participating and I'd like to extend you an opportunity to come back again if you feel that you would like to make some remark to the committee as a whole. We may start it earlier than 9:30. We may move the time up to quarter after 9 or 9 o'clock, and I'd like you to speak to that issue again, Ralph.

Mr. INGERSOLL. Fine.

Senator D'AMATO. With respect to your concern, because I think it might have some merit and Mr. Foss, you might want to comment on that. This goes beyond the issues of mergers and acquisitions and I don't think any of us want to see the capital formation markets of this country unduly limited.

Thank you all for participating.

Fred, this will teach you go to home next time you finish testifying.

The committee stands in recess.

Thank you.

[Whereupon, at 2 p.m., the committee was adjourned.]

IMPACT OF CORPORATE TAKEOVERS

WEDNESDAY, JUNE 12, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 9:05 a.m., in room SD-538, Dirksen Senate Office Building, Senator Alfonse D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Hecht, Gorton, Gramm, Cranston, Sasser, Riegle, and Proxmire.

Also present: Senators Domenici and Metzenbaum.

OPENING COMMENT OF SENATOR D'AMATO

Senator D'AMATO. The subcommittee will come to order.

I am at this point in time going to waive my opening remarks and would ask the subcommittee members to do likewise in the interest of time so that we can hear our colleague who is chairing a Budget Committee hearing at 9:15 and has requested to come on, our good friend, Senator Domenici.

Senator Domenici, good morning.

STATEMENT OF PETE V. DOMENICI, U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator DOMENICI. Thank you very much, Mr. Chairman.

I will be brief. You have a number of witnesses far more expert than I, but let me just say to you, Senator D'Amato and members of the committee, I commend you for conducting these hearings on the takeover issue. I appreciate the opportunity you have afforded me, both in letting me participate in last week's hearings and allowing me to testify today. As I said, my remarks will be brief. I know that the main event follows. Over the past several months I have written several pieces on this issue that in the interest of brevity I would ask they be inserted in the record and ask that they be made part of my remarks at this point.

THEOLOGY OF THE MARKETPLACE

Much of the debate relates to the theology of the marketplace. For quite some time we've been asking questions such as: Are mergers good or bad? Is America sinking under a growing burden of public and private debt? To what extent, if any, should we strengthen or alter regulations? Do raiders keep management on their toes, or do they waste scarce capital resources?

I am not here today to answer these questions. I am not against mergers and acquisition, nor am I against all uses of junk bonds. I believe, however, that there are several public policy issues of concern to the taxpayers that require immediate legislative remedy. And despite the heated disagreement over economic theory, I believe the debate has served to bring us to a consensus on a few public policy issues which I think are really what are at stake here.

I address these issues in a bill that I will introduce later today. Unlike the legislation which I introduced in April, the Securities Safety and Soundness Act, this bill does not place a moratorium on hostile takeovers financed by junk bonds. It's my impression, at least for the time being, that the impetus for such a moratorium has waned with the recent Delaware Supreme Court decision. I'm merely saying that for the time being that seems to be the case, and that the increase in caution being exerted by certain investors in junk bonds as part of takeovers also points to less need for a moratorium.

The public policy steps of which I believe there is growing unanimity for taking action on are: One, junk bond purchases by federally insured financial institutions; and two, the need to enforce existing margin rules.

Our financial institutions are not in good shape and my conversations with various regulatory chairmen have only reinforced this conclusion. I assume from the testimony that you have already heard and that you will hear that you will conclude the same. Banks and thrifts are in trouble and confidence in the safety and soundness of financial system, particularly the savings and loans, has greatly eroded.

The number of problem institutions is at an all-time high, and we've set a record number of mergers by federally backed institutions over the past few years.

What is particularly frightening is the level of reserves left in our insurance funds. Although the FDIC's ratio of reserves to deposits has been increasing over time, it has pumped more money into the system in the past 4 years than it has in the previous half century. The FSLIC is faring even worse; its reserves have shrunk dramatically and may be effectively depleted.

Of course we can't attribute all of these problems—and I am not—to junk bonds. But at the same time, we do not want to exacerbate them by allowing our banks and thrifts to make risky investments. My approach in the bill I will introduce applies existing regulations on federally insured banks and thrifts investments across the board, regardless of where their charters come from. Furthermore, if these institutions do not maintain a minimum net worth of 6 percent, they cannot purchase any amount of these securities. If we do not restrain institutional investments in junk bonds, it is my honest belief that the taxpayers will be the ones who pick up the tab in the event the investments fail.

Let me just mention that I am also concerned about federally insured pension fund investments in junk bonds. The Pension Benefit Guaranty Corporation covers approximately 38 million workers and its operations are similar to that of the FDIC and FSLIC. While I have not chosen to cover this matter since it appears at the

offset to be extraneous to what I have been discussing, I do urge the committee to examine the practices of the pension fund, and its investment practices in particular, with reference to junk bonds.

MARGIN REQUIREMENT

A second area that I feel we can all agree on relates to the margin requirement. The margin rule is already on the books and stipulates that loans for stock purchases cannot exceed 50 percent of the value of the stock being bought. Yet many hostile takeover deals have flagrantly violated this requirement by using shell corporations to leverage up well beyond the 50-percent limit. Such deals obviously circumvent the rule's intent, which is to prevent excessive use of credit and discourage speculation.

If the Federal Reserve feels that it is safe to lower the margin requirement or to spell out exceptions for particular transactions, fine. But until then, let it enforce what the law says now.

I believe, as I state in my bill, that we ought to instruct them to enforce the margin rate and apply it to hostile takeovers by shell corporations.

Mr. Chairman, I don't want to take up any more time. I know that you're looking forward to the panel which follows me. I hope my colleagues will act on what I perceive to be a general consensus on the above points. Many people here today, including myself, have testified on these issues. I think enough has been said and it's time for us to take action and pass some legislation that will solve some of the problems which I have outlined and which you have already and will continue to hear.

Again, in closing, I commend the panel for moving forward on this takeover issue and in particular you, Mr. Chairman, for the interest and diligence you have seen fit to pursue.

I ask that my statement with reference to the bill which I will introduce and articles which I have written and alluded to before be made a part of my testimony, Mr. Chairman.

Senator D'AMATO. So ordered.

[The complete prepared statement follows.]

Statement of Pete V. Domenici

Senator D'Amato and members of the subcommittee, I commend you for conducting these hearings on the takeover issue. I appreciate the opportunities you have afforded me, both in letting me participate in last week's hearing, and allowing me to testify today. I will keep my remarks brief, as I realize that the main event follows me. Over the past several months I have written several pieces on this issue that in the interest of brevity I ask be inserted in the record.

Much of the debate relates to the theology of the marketplace. For quite some time we've been asking questions such as: Are mergers good or bad? Is America sinking under a growing burden of public and private debt? To what extent, if any, should we strengthen or alter regulations? Do raiders keep management on their toes, or do they waste scarce capital resources?

I am not here today to answer these questions. I am not against all mergers and acquisitions, nor am I against all uses of junk bonds. I believe, however, that there are several public policy issues of concern to the taxpayers that require immediate legislative remedy. And despite the heated disagreement over

ECONOMIC THEORY, I THINK THE DEBATE HAS SERVED TO BRING US A CONSENSUS ON THE PUBLIC POLICY ISSUES AT STAKE.

I ADDRESS THESE ISSUES IN A BILL THAT I WILL BE INTRODUCING LATER ON TODAY ENTITLED THE JUNK BOND LIMITATION ACT OF 1985. UNLIKE THE LEGISLATION I INITIALLY INTRODUCED IN APRIL, (THE SECURITIES SAFETY AND SOUNDNESS ACT) THIS BILL DOES NOT PLACE A MORATORIUM ON HOSTILE TAKEOVERS FINANCED BY JUNK BONDS. THE IMPETUS FOR SUCH A MORATORIUM HAS WANED WITH THE RECENT DELAWARE SUPREME COURT DECISION AND THE INCREASE IN CAUTION BEING EXERTED BY CERTAIN INVESTORS IN JUNK BONDS.

THE PUBLIC POLICY STEPS OF WHICH I BELIEVE THERE IS GROWING UNANIMITY FOR TAKING ACTION ON ARE: (1) JUNK BOND PURCHASES BY FEDERALLY-INSURED FINANCIAL INSTITUTIONS AND (2) THE NEED TO ENFORCE EXISTING MARGIN RULES.

INVESTMENTS IN JUNK BOND SECURITIES BY FEDERALLY-INSURED INSTITUTIONS

OUR FINANCIAL INSTITUTIONS ARE NOT IN GOOD SHAPE AND MY CONVERSATIONS WITH VARIOUS REGULATORY CHAIRMEN HAVE ONLY

REINFORCED THIS CONCLUSION. BANKS AND THRIFTS ARE IN TROUBLE AND CONFIDENCE IN THE SAFETY AND SOUNDNESS OF THE FINANCIAL SYSTEM, PARTICULARLY THE SAVINGS AND LOANS, HAS GREATLY ERODED.

THE NUMBER OF PROBLEM INSTITUTIONS IS AT AN ALL TIME HIGH, AND WE'VE SET A RECORD NUMBER OF MERGERS BY FEDERALLY BACKED INSTITUTIONS OVER THE PAST FEW YEARS.

WHAT IS PARTICULARLY FRIGHTENING IS THE LEVEL OF RESERVES LEFT IN OUR INSURANCE FUNDS. ALTHOUGH THE FDIC'S RATIO OF RESERVES TO DEPOSITS HAS BEEN INCREASING OVER TIME, IT HAS PUMPED MORE MONEY INTO THE SYSTEM IN THE PAST FOUR YEARS THAN IT HAS IN THE PREVIOUS HALF-CENTURY. THE FSLIC IS FARING EVEN WORSE; IT'S RESERVES HAVE SHRUNK DRAMATICALLY, AND MAY BE EFFECTIVELY DEPLETED.

OF COURSE WE CANNOT ATTRIBUTE ALL OF THESE PROBLEMS TO JUNK BONDS. BUT AT THE SAME TIME WE DO NOT WANT TO EXACERBATE THEM BY ALLOWING OUR BANKS AND THRIFTS TO MAKE RISKY INVESTMENTS. MY BILL APPLIES EXISTING REGULATIONS ON FEDERALLY-INSURED BANKS' AND THRIFTS' INVESTMENTS ACROSS THE BOARD, REGARDLESS OF WHERE THEIR CHARTERS COME FROM. FURTHERMORE, IF THESE INSTITUTIONS DO NOT MAINTAIN A MINIMUM NET WORTH OF 6 PERCENT, THEY CANNOT PURCHASE

ANY AMOUNT OF THESE SECURITIES. IF WE DO NOT RESTRAIN INSTITUTIONAL INVESTMENTS IN JUNK BONDS, THE TAXPAYERS WILL BE THE ONES WHO PICK UP THE TAB IN THE EVENT OF FAILURES.

LET ME JUST MENTION THAT I AM ALSO CONCERNED ABOUT FEDERALLY-INSURED PENSION FUND INVESTMENTS IN JUNK BONDS. THE PENSION BENEFIT GURARANTY CORPORATION COVERS APPROXIMATELY 38 MILLION WORKERS AND ITS OPERATIONS ARE SIMILAR TO THAT OF THE FDIC AND FSLIC. I URGE THE BANKING COMMITTEE TO EXAMINE THE PRACTICES OF PENSION FUND INVESTMENTS IN JUNK BONDS.

ENFORCING THE MARGIN RULE

A SECOND AREA THAT I FEEL WE CAN ALL AGREE ON RELATES TO THE MARGIN REQUIREMENT. THE MARGIN RULE IS ALREADY ON THE BOOKS AND STIPULATES THAT LOANS FOR STOCK PURCHASES CANNOT EXCEED 50% OF THE VALUE OF THE STOCK BEING BOUGHT. YET MANY HOSTILE TAKEOVER DEALS HAVE FLAGRANTLY VIOLATED THIS REQUIREMENT BY USING SHELL CORPORATIONS TO LEVERAGE UP WELL BEYOND THE 50% LIMIT. SUCH DEALS OBVIOUSLY CIRCUMVENT THE RULE'S INTENT TO PREVENT EXCESSIVE USE OF CREDIT AND DISCOURAGE SPECULATION.

IF THE FEDERAL RESERVE FEELS THAT IT IS SAFE TO LOWER THE MARGIN REQUIREMENT, OR TO SPELL OUT EXCEPTIONS FOR PARTICULAR DEALS, FINE. BUT UNTIL THEN, LET'S ENFORCE WHAT THE LAW SAYS NOW.

MR. CHAIRMAN, I DON'T WANT TO TAKE UP ANY MORE TIME, AND I KNOW THAT WE ARE ALL LOOKING FORWARD TO THE PANEL WHICH FOLLOWS ME. I HOPE MY COLLEAGUES WILL ACT ON WHAT I'VE PERCEIVED TO BE A GENERAL CONSENSUS ON THE ABOVE POINTS. MANY PEOPLE HERE TODAY, INCLUDING MYSELF, HAVE TESTIFIED BEFORE ON THESE ISSUES. ENOUGH HAS BEEN SAID, AND IT IS TIME FOR CONGRESS TO PASS LEGISLATION AND REMEDY SOME OF THE PROBLEMS I HAVE OUTLINED. AGAIN, I COMMEND THIS PANEL FOR MOVING FORWARD ON THE TAKEOVER ISSUE.

Fools and Their Takeover Bonds

By Pete V. Domenici

I have been fascinated by the intensity of the debate on this page over the risks of non investment grade, or "junk," bonds, particularly in hostile takeovers. Literary flourishes reached a high point with the designation of junk bonds as "swill." But so far the debate has overlooked the two issues that will most likely result in a federal regulatory response.

The first of these is the recent and growing role of federally insured lending institutions and government-backed pension funds in purchasing junk bonds. The 1982 deregulation of financial markets and the Depository Institutions Deregulation and Monetary Act of 1980 were designed to give federally insured thrifts more elbow room in the financial marketplace to meet their commitment to provide home mortgages. Their involvement in the high-stakes game of corporate takeovers has led Chairman Edwin Gray of the Federal Home Loan Bank Board to characterize the thrifts' participation as "heads I win, tails the FSLIC loses." Since 1981, more than 1,000 federally insured thrifts have been merged or liquidated.

The second issue that will prompt eventual federal action is the use of junk bonds to circumvent the Federal Reserve's margin requirement (Regulation G). This rule provides that loans for stock purchases cannot exceed 50% of the value of the stock being bought. In the military there is a saying that safety regulations are written in blood. The margin requirement is written in the blood of 1929.

Several of the recent hostile takeovers have made a mockery of the margin requirement. Shell corporations have issued junk bonds to finance stock purchases entirely with borrowed funds. Because there is no functional difference between bonds and loans in this situation, the margin requirement is unjustifiably circumvented.

I believe that responses by Congress and the Federal Reserve are inevitable. But we need to take care to craft legislation that preserves the advantages of hostile mergers, while limiting the risks of using junk bonds in such takeovers. Accordingly, I have proposed a temporary moratorium on hostile mergers using junk bonds to give Congress and the regulatory agencies time to act.

Opponents of a moratorium, or for that matter, any federal action, have argued that hostile takeovers using junk bonds are a healthy development. This conclusion is based on a three-part argument that (1) history has shown junk bonds are not inordinately risky; (2) the present round of takeover activity will lead to better management and healthier companies, and (3) buying out stockholders with junk bonds is the way the market makes more efficient use of capital. The first two arguments reflect more fancy than fact. The third has some superficial appeal but, under close scrutiny, proves irrelevant to the particular policy issues facing us.

1. *The Risks of Junk Bonds.* The past offers us no guide to the risks of recently issued junk bonds. In 1977, $1 billion of junk bonds was issued. In 1984, the market for junk bonds was more than $15 billion. In the past, these bonds were issued by growth companies or troubled industrial giants such as Chrysler Corp. In contrast, the junk bonds of today are being issued by shell corporations to finance highly leveraged acquisitions. In addition to these dramatic differences in volume, and the quality of the issuer, 80% of these bonds have never faced the test of an economic downturn or a rise in interest rates. Comparing today's explosion of junk bonds with their use in the late 1970s is like comparing World War II with the Civil War simply because gunpowder was used in both.

The recent default of Sharon Steel Corp. on its two most recent payments on $426 million of these bonds and Metromedia Inc.'s decision to sell seven TV stations to service the debt on its junk bonds are timely reminders of the risks involved. Metromedia sold $1.3 billion of junk bonds in two hours only last year, even though the prospectus admitted: "Based on current levels of operations and anticipated growth, the company does not expect to be able to generate sufficient cash flow to make all of the principal payments due on the notes. . . ." It goes on to state, "Based on current levels of operations, the company's cash flow would be insufficient to make interest payments. . . ."

Comparing today's explosion of junk bonds with their use in the 1970s is like comparing World War II with the Civil War because both used gunpowder.

The importance of Metromedia lies in that it is not part of a declining industry, but rather part of the vibrant communications sector. Moreover, the Metromedia sale comes in good economic times, not bad. As for the future, we need only remember the observation of John Shad, chairman of the Securities and Exchange Commission: "The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow."

2. *The Management Smoke Screen.* Talk of improving management is a smoke screen for the raiders' scorched-earth tactics in the energy industry. Phillips Petroleum Co. has more than 70% of its cash flow dedicated to debt service. Its exploration and development budget is down by 32% ($260 million). The last offer from Carl Icahn would have made the company's debt-to-equity ratio 14 to 1 (at 6 to 1 Chrysler came to the feds hat in hand).

By attacking Uniroyal Inc., whose stock has increased fivefold in the past three years, and Unocal Corp., whose cost of finding oil is the lowest of any major oil company ($6 a barrel vs. $14 for Mesa Petroleum Co. and $22 for Chevron Corp.), the raiders further belie any interest in improving management.

Documents unearthed during the Unocal takeover effort and reported in the press give a truer picture of raider intentions. They are looking for targets with two characteristics: strong cash flow and little debt. The quality of management is irrelevant. The court documents also undercut any contention that the raiders are concerned with the long-range health of the target company. In Unocal's case, the raider's plan for spending for exploration and development in the U.S. is scheduled to decline from $850 million a year in 1984 to $100 million a year in 1990. Foreign exploration would drop from $355 million a year in 1983 to zero in 1988. We are speaking not of restructuring, but of liquidation.

3. *Markets and Predators.* An argument with surface appeal contends that buying out stockholders at a premium with borrowed money (substituting debt for equity) frees up stockholders to take their money elsewhere and put it in industries that will yield a higher return. Just as nature has a role for predators, the argument continues, so the financial jungle has a use for them. The process is not for the squeamish, but ultimately benefits us all. And just because we may not like the personalities involved, whoever said sharks were friendly?

Although flawed—stockholders can sell anytime, not just during a takeover, and much of the economic incentive comes from the tax advantages of using debt rather than putting capital to higher uses—this argument at least has the virtue of describing the motives of the participants.

But despite its descriptive value, this argument is devoid of policy consequences. Specifically:

- It does not address whether the taxpayer should shoulder any of the risk of having federally insured institutions participate in corporate takeovers using junk bonds. Prior articles on this page have emphasized the savvy of participants such as the Belzberg family or Saul Steinberg, but not the liability of the taxpayer.
- It has no impact on the need to enforce margin requirements. If it does, then proponents of junk-bond-financed takeovers are the ones asking for a major change.
- It is also irrelevant to the issue of government intervention. The present takeover contests are being conducted within a long-established, elaborate framework of federal and state laws and regulations with many judges checking to see that every "i" is dotted.

A moratorium on hostile takeovers using junk bonds would give us the time needed to enact the minimal precautionary steps to preclude federally insured institutions from purchasing junk bonds and to scrutinize the present round of takeovers to ensure that the margin requirements are fully enforced. Timely action is needed to reduce the greatest risk of all, the risk to our nation's financial system. For more than five years the Federal Reserve has been navigating through a seemingly endless financial mine field. The debt volcano of the lesser-developed countries could erupt again. Savings and loan associations, as noted earlier, continue to succumb at alarming rates. And the Ohio banking crisis is not fully behind us. Into this fragile situation, junk-bond advocates are urging us to pump unprecedented amounts of high-risk corporate debt. Market theorists love to rhapsodize about the wisdom of markets. But part of this wisdom consists of dealing harshly with fools who believe that the good times are without end.

Sen. Domenici (R., N.M.) is chairman of the Budget Committee.

STATEMENT OF SENATOR PETE V. DOMENICI

INTRODUCTION OF

SECURITIES SAFETY AND SOUNDNESS ACT OF 1985

April 23, 1985

MR. DOMENICI. Mr. President, today I am introducing the Securities Safety and Soundness Act of 1985 to temporarily halt certain financing schemes that threaten our capital markets and financial institutions. Specifically, the proposed Act places a moratorium through the remainder of this year on the use of so-called junk bonds to finance hostile takeovers. In addition, the bill permanently prohibits federally-insured financial institutions from purchasing additional junk bonds.

As we are all well aware, our nation's deficit has reached unprecedented proportions; $185 billion in 1984 and a projected $222 billion in 1985. While on Capitol Hill we are making efforts to curb government expenditures by $52 billion and making sure that every dollar is used wisely, it seems ironic that Wall Street is engaging in $14 billion worth of takeovers which could result in the infusion of massive corporate debt in the economy. I further believe that the financial soundness of our federally insured depository institutions is being undermined when these institutions participate in, and act as the secondary market for these non-investment grade securities.

Of course not all mergers and acquisitions are bad and neither is issuing non-investment quality bonds in certain instances. My concerns rest with the recent rash of corporate takeovers that have used junk bonds with the expectation of selling the acquired firm's assets to service the debt. The result is reduced research and development and exploration

[illegible], lost jobs, short-sighted management, and potential disaster in the event of an economic downturn. These concerns have led me to introduce this bill. The threat to the stability and financial soundness of some of our financial institutions lends additional support to this measure.

The Business Roundtable cites three additional reasons for curtailing takeovers:

-- Creation of a speculative climate that encourages professional traders to become shareholders with the objective of seeing the company sold.

-- Financing of the acquisition largely from the assets of the target company followed by liquidation of the assets to pay off the debt.

-- Loading the company with debt that weakens it for the future.

I want to emphasize that my proposal regarding takeovers is a temporary one; however, my proposal regarding financial institutions would be permanent. I am not wedded to the bill's precise language, rather I am interested in focusing the debate on questionable practices.

History has shown us a number of cases where speculative "bubbles" have hurt investors, corporations, and the economy as a whole. We can ill afford to ignore warning signals of impending trouble. Thus, while various committees continue to examine problems associated with hostile takeovers, I urge us to apply caution and temporarily stop the use of this risky financing mechanism until we can learn all facts and craft legislation that appropriately addresses the situation.

A number of my colleagues have introduced legislation which deals with hostile takeovers and questionable practices associated with them. I am a cosponsor of Senator Chafee's and Senator Boren's bills. I also appreciate the efforts Senator Metzenbaum is initiating to create a more rational and fairer tender offer process with the Shareholder Fairness Act.

Before turning to the major elements of my bill I would like to describe how junk bonds are used in hostile takeovers. Following the bill's description I will detail some of my reasons for advocating a moratorium.

JUNK BONDS IN HOSTILE TAKEOVERS

A junk bond is a non-investment grade (investment grade is defined as issues rated BB or higher by Standard and Poor's and Baa or higher by Moody's), high-yield corporate security.

The new issue junk bond market has grown from approximately $250 million in 1979 to $14.3 billion in 1984. The secondary market in outstanding junk issues is estimated at $65 billion. Examples of recent hostile takeover bids that included junk bonds are as follows:

-$5.4 billion for Ted Turner to take over CBS.

-$3-3.4 billion for Mesa Partners II to take over Unocal Corporation.

-$1.78 billion for Golden Nugget Inc. to take over Hilton Hotels Corporation.

-$1.02 billion for Lorimar to take over Multimedia, Inc.

-$807 million for Sir James Goldsmith to take over Crown Zellerbach.

-$600 million for Coastal Corporation to take over ANR Company.

-$395 million for Triangle Industries to take over National Can Corporation.

-$275 million for Carl Icahn to take over Uniroyal.

All of these transactions were to be financed with non-investment quality bonds carrying interest rates of 15% to 18%. These interest rates are generally higher than the rates of return the businesses are likely to earn in periods of economic downturn. If a recession should occur, the new management may experience difficulties in servicing the speculative debt. The leveraging of corporate America today may result in significant bankruptcies for corporations and banks tomorrow.

BILL PROVISIONS

My bill is simple: it amends the Securities Exchange Act of 1934 by establishing a moratorium through December 31, 1985 on hostile takeovers where at least 20 percent of the acquisition is financed by junk bonds. A takeover is considered to be hostile if the acquirer would (a) be entitled to 15 percent or more of the target firm's securities and (b) the acquisition is disapproved by a majority of the issuer's board of directors who are not officers or employers.

The second major component of the Securities Safety and Soundness Act focuses on depository institutions that are federally insured. Such institutions are prohibited from adding non-investment grade obligations to their portfolios.

The exact language of the bill is included at the end of my remarks. I would now like to address more fully the concerns I alluded to above.

EXPLORATION/RESEARCH AND DEVELOPMENT DECLINE

A December 3, 1984 report by Salomon Brothers Inc. indicates that major oil company U.S. exploration and production expenditures for 1985 are below the total for 1984. The surveyed companies attributed this decline to the recent trend of mergers among large oil companies. Furthermore, many companies expected

to underspend their original 1984 budgets (43% of those surveyed). The most common reason for this underspending was to conserve capital to acquire companies or properties.

Two examples of firms that have been involved in hostile takeovers and have reduced their U.S. exploration and production expenditures are Chevron and Phillips Petroleum. The Salomon survey shows that Chevron's expenditures in this area dropped 9% and Phillips' fell over 32% between 1984 and budgeted expenditures for 1985. The majority of other surveyed firms either maintained or increased their expenditures.

Not only is the domestic exploration of merged companies suffering, exploration and drilling programs overseas are similarly affected. Projects in the Gulf of Mexico, China, and Kenya have been postponed.

Operations are closing and people are being laid off in the R & D areas. Gulf Oil, bought by Chevron, has recently closed its Pittsburgh research facility. Both of the firms, along with other merged companies, have withdrawn research grants from MIT, the University of Texas, Stanford, Columbia, the Colorado School of Mines, the University of Wyoming, and the University of Southern California.

When debts must be serviced, R & D is often the first to go. Experience in the energy industry is demonstrating that buying out present stockholders with debt exacerbates this short sighted trend.

Right now roughly one half of this nation's imported oil comes from an area of the world where men are killing each other with reckless abandon. I believe that all of us have a stake in continuing to explore for more oil and in looking for alternative sources of energy. This becomes even more important in light of Department of Energy projections that show our imports doubling over the next decade. The odds are high enough that we will suffer further disruptions in supply from the Middle East over the next decade that the short-term view imposed by the oil industry's need to meet its increased debt obligations will be considered a grave mistake.

ENSURING THE INTEGRITY OF FINANCIAL INSTITUTIONS

Deregulation of both the asset and liability sides of the balance sheet under the Garn-St-Germain Act and Depository Institutions Deregulation and Monetary Control Act of 1980 did not envision that federally insured institutions would become participants in or involved in the secondary market for non-investment quality bonds. Such speculation has nothing to do with helping savings and loans provide housing to America. Such speculation has nothing to do with helping banks compete with Sears and Roebuck. Furthermore I do not believe that our federal deposit insurance fund should be jeopardized to insulate such financial institutions from this type of investment practice. Regardless of the Congressional intent, financial institutions

and pension funds are actively investing in non-investment quality bonds and securities.

Many proponents of these bonds point to their historically low default rate. But with the rapid emergence of new uses for these securities we should not assume a similar rate for the future. I am not persuaded by performance studies on bonds issued by companies like Chrysler. These studies are unpersuasive and do not address my concerns about the risk involved in this new generation of bond issuers. It is an understatement to say that the quality of a bond issued by a new shell corporation created as part of a hostile takeover bears any resemblance to a well-established company. However, it is no understatement when I say that the volume of these new bonds is astronomical. Quality and volume are two reasons why this question needs to be resolved soon.

The prospect of an economic downturn is even more alarming. Approximately 80% of outstanding "new issue" non-investment quality bonds were issued during a time of economic expansion and generally declining interest rates. In the event of a recession, companies laden with debt could experience severe cash flow problems. These issuers are likely to default with much of the financial loss being shouldered by federally insured financial institutions. FSLIC and FDIC are not insurances policies against speculative risk.

Let me suggest that unless we take action to prohibit federally insured financial institutions from participating in, and serving as part of the secondary market for these bonds,

sometime in the not to distant future, the Senate will be debating another bailout for our financial institutions. I would venture to guess that the institutions will say, "help us, we only bought non-investment grade investments because you allowed us to."

I am not alone in my concern for this issue. The Federal Home Loan Bank Board is working on a study to determine the extend of S&L participation. Chairman Grey at the Bank Board has expressed his concern and caution. By introducing this bill I am expressing my concern and caution.

CONCLUSION

In summary, I would like to reiterate that although I do not portend to be an expert on the technicalities of hostile acquisitions and methods used to finance them, I strongly believe in the need to maintain a healthy economy and the safety and soundness of our financial institutions. And this is the gist of my bill. By placing a temporary moratorium on hostile takeovers which are financed by take-over securities and prohibiting federally insured financial institutions from investing the taxpayers' funds into these high risk securities I hope to buy time for us to examine the complexities surrounding this issue.

The fact that numerous agencies, including the Securities and Exchange Commission, the Federal Reserve, Department of Treasury, Department of Labor, Federal Home Loan Bank Board, and Pension Benefit Guaranty Corporation are all concerned with these

so-called junk bonds lends credence to the degree of complexity we are talking about. I hope that my colleagues will join me in endorsing a cautious approach and I request unanimous consent that the Record be left open until the end of the day so that additional cosponsors of the Securities Safety and Soundness Act of 1985 may be added.

I ask further unanimous consent that the three articles I am sending to the desk also appear in the Record.

Thank you, Mr. President.

Senator D'AMATO. Thank you very much, Senator Domenici, and we recognize that you have another hearing, an important event that you will be chairing, and we wish you good luck.

Senator DOMENICI. Thank you very much.

Senator D'AMATO. Does anyone have any questions?

[No response.]

Senator D'AMATO. We will move to our second panel now, Sir James Goldsmith, Fred L. Hartley, and T. Boone Pickens.

Gentlemen, I understand that Mr. Hartley has an airplane that he's worried about catching to take him to London, I think is what you said, Mr. Hartley, and inasmuch as we would like to hear all of you and I think the panel will have a number of questions, I'm going to ask that you attempt to summarize. We will take your entire statement as if read in its entirety and you can make the main points. We are delighted that you have taken from your time to be here.

STATEMENT OF FRED L. HARTLEY, CHAIRMAN AND PRESIDENT, UNOCAL CORP.

Mr. HARTLEY. Thank you, Mr. Chairman. I appreciate your courtesy this morning.

Mr. Chairman and members of the subcommittee, my name is Fred L. Hartley, and I am chairman and president of Unocal Corp., and I appreciate this opportunity to be here today. With your permission, I will submit my written statement for the record and provide a 10-minute summary.[1]

OPPOSE RAIDERS

Let me say at the outset that I do not oppose mergers but the issue here today is not mergers; it is raids. In particular, I oppose

[1]The article from the American Lawyer, "The Roaring Eighties," submitted by Fred Hartley, is a duplication of a previous submission by Alexander Trowbridge. This article can be found on p. 924.

hostile takeovers in which corporate raiders use junk bonds to convert or attempt to convert a large part of the company's equity into debt and milk its assets to repay the debt and ultimately destroy or lead to destroy the company for their personal gains.

Some observers defend such activity in the name of economic efficiencies and sanctimonious takeover artists people call themselves friends of the shareholders. Both claims are nonsense.

In the oil industry which I know best, these raids have killed off once competitive companies and caused others, including Unocal, to curtail spending on oil exploration and on research and development at the very time when America's oil imports are again increasing. Raiders have looted target companies and left remaining shareholders burdened with new debt. What kind of efficiency is this? What kind of friends are these?

These raids and bustup takeovers have not caused one new technological innovation; they have not strengthened the companies; and they certainly have not bolstered the Nation's economy. While we may be able to compete with each other at home if all companies are similarly debt ridden, certainly we could no longer succeed in the international markets where we were once world leaders.

As I believe you all know, Unocal has recently fought off a hostile raider. The media hailed our success, but I don't see it as a total victory. Since we were forced to take on more than $4 billion in new debt, we will now obviously have to do things differently, including less R&D and less domestic exploration. And our victory does not seem to have significantly altered the political, regulatory, and business environment that has nurtured this recent merger mania.

Our battle began with the February 14 announcement of Mesa's so-called investment in Unocal. Soon they ran a two-front war. They initiated a proxy fight to delay our annual meeting and a tender offer to acquire 51 percent of the company. The key shock came on April 15. Mesa's tender offer had been designed to purchase half of the company at a grossly inadequate cash price and to squeeze out the remaining 49 percent of the shares and 90 percent of the shareholders by forcing an exchange of shares for deeply subordinated debt securities.

The Unocal board countered with a conditional back-end tender to buy the remaining 49 percent of our shares at $72 a share if Mesa's tender offer was successful, and to protect our non-Mesa shareholders by specifically excluding Mesa as a participant.

After a series of legal battles, on May 17, the Delaware Supreme Court ruled that the board could properly exclude the raiders. Please let me stress that the ruling does not give blanket approval to a draconian maneuver. As the court put it, it does give the board of directors the authority to act to protect the interest of the remaining shareholders if in its opinion one or more shareholders is acting like a predator, as in our case, trying to grab control substantially below the company's true value.

We are confident anyone who studies the facts carefully will agree that the Delaware Supreme Court ruled properly. Mesa's hostile tender offer was a coercive two-tier, front-end loaded offer at a grossly inadequate price. If it had been successful, most of Unocal's shareholders with approximately half the shares outstanding

would have been forced to exchange their share for debt securities of dubious value.

On the other hand, our back-end exchange offer for $72 a share in notes was a measured response tendered to prevent this abusive deal and in fact our tender offer was fully and enthusiastically subscribed.

In addition, we won our simultaneous proxy fight by about a 2-to-1 margin.

Mr. Chairman, I would stress to you that our individual shareholders, those are long-time investors, not casino operators, voted by an 8-to-1 margin in favor of management.

The Delaware ruling recognizes the coercive and inequitable nature of junk finance raids and works to protect shareholders from such twists and deceits. As a result, the playing field of the corporate takeover game has been leveled to some extent.

Not surprisingly, we now hear groans of anguish from the raiders and their support teams who previously had the rules and the profits in their favor.

Following this decision we could negotiate a settlement on equal footing. After 2 days of meetings, we reached an agreement on May 20. In return for the right to participate in the limited portion of our share exchange, the Mesa group along with financial backers, Drexel Burnham Lambert, Inc., agreed to cease immediately all efforts to take control of Unocal or otherwise influence our policies or affairs. Mesa may not buy any new shares of Unocal stock for 25 years, and the shares it currently owns must be sold under carefully controlled conditions. In addition, Drexel Burnham will not buy or finance the purchase of any Unocal shares for the next 3 years, except in the ordinary course of its brokerage activities.

Our settlement involved no green mail. Nor did we pay a single penny of Mesa's expenses—often the device by which green-mail payments are disguised so that the raiders' self-righteous expressions can continue, their profits can be given favored-tax treatment, and perhaps the public can be deceived. Mesa will end up losing money on its Unocal adventure.

To be specific, Unocal shareholders have a total value at today's market prices of $47.90 and Mesa partners of $45.15, a difference of $2.72 per share. On Mesa's 23,700,000 shares, that's a relative negative greenmail payment of $62,999,000.

TOTAL COSTS IN VICINITY OF $661 MILLION

In addition, their costs are in the vicinity of $120 million. Further, Mesa's shares have dropped from $20.65 per share on January 1, 1985, to $13.50 on June 10, 1985, a decline of $7.15 per share. This reduced Mesa's shareholders' value $479,692,000. Adding the other losses, the grand total is $661,680,000. It looks like Mesa needs to be restructured and vice president of Donaldson-Ludkin Jenerette, the self-appointed king of the oil analysts who predicted Unocal's demise is my candidate for the job. I refer you to the May 1 article by Mr. Kirk Wolfe, entitled "There Goes Another One." We were the other one. I would like you to see the article of May 1 entitled "There Goes Another One," and if you read that article it

will give you the flavor of the situation. Its demise of Unocal was premature.

I am convinced we won this vicious battle because we had a highly talented team fully backed by a strong board of directors, working on a cause that we all knew was just, protecting the financial rights of our shareholders and may I stress, sir, the human rights of our employees. If you don't think that isn't important, go to Pittsburgh these days and look around at the empty buildings and the absence of people. They comprise a large group of our shareholders.

If our innovative and spirited defense proves responsible for bringing this current takeover wave to a halt or even slowing it down, as some are now saying, then all the misery of the last 3 months will be worth it.

Although we have fought through our takeover crisis, the other companies are now on the firing line. What should the administration, the Congress, the courts, and various regulatory agencies do about these unproductive, highly speculative raids? I recommend the following 10-step program.

One, the most urgent need is for a legislated moratorium on hostile takeovers—a sort of cooling off period—while Congress sorts out the issues and takes the necessary corrective steps.

Two, the SEC and other regulatory agencies should take steps to make their investigations timely and serious. They should impose real sanctions rather than wrist slaps when the situation demands. Perhaps Congressman John Dingell's recent request to the SEC for a full record of enforcement information will spark some interest among both raiders and regulators.

Three, the Federal Reserve Board should examine the financial backing for these raids. For instance, a private individual can only margin—that is borrow to buy—50 percent of the cost of a stock purchase; but the raiders borrow or receive commitments for virtually 100 percent of the cost of a raid. The Federal Reserve Board's margin rules should be clarified and enforced.

Four, the rules covering announcement of stock ownership and intention should be changed, closing the 10-day window after the 5-percent threshold has been reached. The only purpose that window now serves is to allow the raiders to buy more shares without public knowledge.

Five, there should be action to prevent the current raider practice of announcing a tender offer before the financing is arranged and all the necessary loan commitments have been signed. The current system is virtual extortion. It allows raiders to issue threats rather than finance loans; it saves them from making all necessary loan commitments, and thus saves them fees and interest that they should have at risk if they are serious about their so-called takeover bid. It may also mean that some commitments are made that cannot be backed; but the threat can still seem very real.

Six, State and Federal regulatory agencies should examine the practices of pension funds, insurance companies, and some banks, and savings and loans that invest their clients money in the high-risk, takeover junk bonds that support these hostile raids. Our financial institutions should concentrate on loans that create jobs and add to the Nation's real output, not on loans that fuel the spec-

ulator and the takeover artist. Since many of those financial institutions are insured by Government agencies, the taxpayers are assuming the risk for these raider schemes; yet we reap no benefit from these raiding schemes. In fact, we are damaged by them.

Seven, the rules governing tender offers should be modified to give the target company an adequate time to evaluate the proposal and to prepare counteraction if warranted. I can attest from personal experience that the present 20 business days is woefully short; 60 business days would be more appropriate.

Eight, Congress should prohibit two-tier tender offers. No shareholder in a target company should be coerced into tendering quickly for an inadequate price simply to escape being buried under back-end junk.

Nine, related to that same point, any hostile raider who acquires over, say, 20 percent of a company's stock should be required to offer for 100 percent of one price, unless the company's board of directors approves some other arrangement.

Ten, my final concern lies outside of the jurisdiction of this committee but should be considered by Congress—the present tax system favors debt over equity, the raider over the defender, the short term over the long term. It favors the raider by permitting the deduction of interest on borrowed money used for corporate takeovers, and in the way raiders can report expenses. As a result, Federal revenues are lower and American taxpayers subsidize part of the corporate takeover game. This is not free enterprise, and it is nothing that should continue.

In addition, there should be punitive taxes to end green mail, legal blackmail by which companies buy back a raider's stock holding at a premium, to the detriment of other shareholders. This may be difficult, because green mail comes in many disguises. But Congress should try to end it.

These and other things must be done and quickly. The American economy needs strong, productive companies to help fuel its long-term growth. The raiders are working not for America's best interest, but only for their own.

Let's face it. The hostile raid on Unocal was a highly engineered conspiracy of Mesa, of some banks, of investment bankers, and their greedy participants in junk bonds, and lastly a ghastly collection of lawyers.

Senator D'AMATO. Always the lawyers, Mr. Hartley. Governor Cuomo recently said something, an old Sicilian proverb: "Better a mouse in the mouth of a cat than a client in the clutches of his lawyer." [Laughter.]

Senator HECHT. Do you want a second to that? [Laughter.]

Mr. HARTLEY. Gentlemen, freedom has a price, but I'm happy to tell you it feels good when you support your country and its Founding Fathers. Now it's your turn to destroy the financial barbarians. Please do it soon.

Senator D'AMATO. How should we do it, with bows and arrows or shotguns?

Mr. HARTLEY. Mr. Chairman, I think you know how to do it just as well as I do.

Senator D'AMATO. I hope you will give us an opportunity to ask one or two questions, but go ahead.

Mr. HARTLEY. Certainly.

Now it's your turn to destroy the financial barbarians. Please do it soon because—and I want to stress this to you, sir—the whole world is laughing at us, the United States, especially the Japanese.

[The complete prepared statement and additional material follow:]

TESTIMONY OF FRED L. HARTLEY OF UNOCAL CORP.

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

MY NAME IS FRED L. HARTLEY. I AM CHAIRMAN AND PRESIDENT OF UNOCAL CORPORATION, AND I APPRECIATE THIS OPPORTUNITY TO BE HERE TODAY.

AMERICAN INDUSTRY HAS BECOME A BATTLEGROUND OF STOCK RAIDS, HOSTILE TAKEOVER ATTEMPTS AND FORCED BREAKUPS. EACH DAY'S PAPER LISTS THE COMPANIES CURRENTLY UNDER SIEGE, LIKE THE CASUALTY REPORT FROM A DISTANT FRONT. UNOCAL CORPORATION HAS JUST SUCCESSFULLY FOUGHT OFF SUCH A RAID; AND NOW THAT OUR DUST IS SETTLING, I'D LIKE TO OFFER A FEW THOUGHTS.

I WANT TO STATE AT THE OUTSET THAT I DO NOT OPPOSE MERGERS. MANY CAN BE PRODUCTIVE. INDEED, UNOCAL IS THE PRODUCT OF MORE THAN ONE MERGER IN ITS 95 YEAR HISTORY. BUT THE ISSUE HERE IS NOT MERGERS, IT IS RAIDS. IN PARTICULAR, I OPPOSE HOSTILE TAKEOVERS IN WHICH CORPORATE RAIDERS USE JUNK FINANCING TO CONVERT A LARGE PART OF A COMPANY'S EQUITY INTO DEBT, MILK ITS ASSETS TO REPAY THE DEBT, AND ULTIMATELY DESTROY OR NEARLY DESTROY THE COMPANY FOR THEIR PERSONAL GAINS.

SOME OBSERVERS DEFEND SUCH ACTIVITY IN THE NAME OF "ECONOMIC EFFICIENCY." TAKEOVER ARTISTS SELF-RIGHTEOUSLY CALL THEMSELVES "FRIENDS OF THE SHAREHOLDER." SUCH CLAIMS ARE NONSENSE. IN REALITY, CORPORATE RAIDERS ARE WREAKING HAVOC WITH U.S. INDUSTRY, REDUCING COMPETITION AND THROWING THOUSANDS OF SKILLED PEOPLE OUT OF WORK.
IN THE OIL INDUSTY, WHICH I KNOW BEST, THESE RAIDS HAVE KILLED OFF ONCE-COMPETITIVE COMPANIES AND CAUSED OTHERS -- INCLUDING UNOCAL -- TO CURTAIL SPENDING ON OIL EXPLORATION AND ON RESEARCH AND DEVELOPMENT AT THE VERY TIME WHEN AMERICA'S OIL IMPORTS ARE AGAIN INCREASING. RAIDERS HAVE LOOTED TARGET COMPANIES, TAKEN IMMENSE PERSONAL PROFITS, AND LEFT REMAINING SHAREHOLDERS CRUSHED WITH NEW DEBT. WHAT KIND OF EFFICIENCY IS THIS? WHAT KIND OF "FRIENDS" ARE THESE?

THESE RAIDS AND BUST-UP TAKEOVERS HAVE NOT INSPIRED ONE NEW TECHNOLOGICAL INNOVATION; THEY HAVE JUST DRAINED OFF INVESTMENT CAPITAL. THEY HAVE NOT STRENGTHENED COMPANIES; THEY HAVE WEAKENED THEM, LOADING SURVIVING FIRMS WITH ONEROUS NEW DEBT. THEY HAVE NOT STRENGTHENED THE NATION'S ECONOMY; THEY HAVE WEAKENED IT. WHILE WE MAY BE ABLE TO COMPETE WITH EACH OTHER AT HOME IF ALL COMPANIES ARE SIMILARLY DEBT-RIDDEN AND WEAKENED; CERTAINLY WE CAN NO LONGER SUCCEED IN THE INTERNATIONAL MARKETS WHERE WE WERE ONCE WORLD LEADERS.
IT IS A DANGEROUS MYTH THAT COMPANIES TARGETED BY RAIDERS ARE USUALLY MISMANAGED, UNSUCCESSFUL OR WEAK; QUITE THE CONTRARY. UNOCAL, FOR INSTANCE, FINDS OIL AT LOW COST; WE ARE MORE PROFITABLE, AND HAVE CONSISTENTLY PROVIDED BETTER RETURNS TO OUR INVESTORS THAN MOST OF OUR COMPETITORS. WE HAVE KEPT OUR DEBT BURDEN LOW; AND WE ARE ACKNOWLEDGED LEADERS IN RESEARCH AND ALTERNATIVE ENERGY SO IMPORTANT FOR OUR NATION'S FUTURE.

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EVEN SO, WE BECAME A RAIDER'S TARGET. AS I BELIEVE YOU ALL KNOW, UNOCAL HAS RECENTLY FOUGHT OFF THE RAID; AND THE MEDIA HAVE HAILED OUR SUCCESS. BUT I DON'T SEE IT AS A TOTAL VICTORY BECAUSE, IN FENDING OFF THE HOSTILE TAKEOVER ATTEMPT THAT WOULD HAVE DESTROYED UNOCAL, WE WERE FORCED TO TAKE ON MORE THAN $4 BILLION IN NEW DEBT. WE WILL NOW OBVIOUSLY HAVE TO DO SOME THINGS DIFFERENTLY -- INCLUDING LESS R & D AND LESS DOMESTIC EXPLORATION. AND OUR VICTORY DOES NOT SEEM TO HAVE SIGNIFICANTLY ALTERED THE POLITICAL, REGULATORY AND BUSINESS ENVIRONMENT THAT HAS NURTURED THIS RECENT PLAGUE OF RAIDS.

MUCH OF THE CURRENT UPHEAVAL IS DUE TO A DESTRUCTIVE NEW WEAPON IN THE CORPORATE RAIDERS' ARSENAL -- TAKEOVER JUNK. THESE BONDS ENABLE CORPORATE RAIDERS TO "BORROW" VIRTUALLY 100 PERCENT OF THE COST OF AN ACQUISITION IN ADVANCE -- WITH LITTLE OR NO SECURITY -- ON THE PROMISE THEY WILL BUST UP THE TARGET COMPANY TO REPAY THE LOAN. THESE ARE WEAPONS CREATED AND USED SOLELY FOR THE CORPORATE QUICK KILL. WITH THEM, A RAIDER CAN CONVERT A COMPANY'S EQUITY INTO DEBT, SLASH RESEARCH AND EXPLORATION, MILK ASSETS AND TAKE THE MONEY AND RUN.

THESE, THEN, ARE THE REASONS THAT CONGRESS, THE ADMINISTRATION AND THE REGULATORY AGENCIES SHOULD BE CONCERNED -- CORPORATE RAIDS ARE DAMAGING THE VERY ECONOMIC FABRIC OF THE NATION.

WE KNOW, FROM WRITTEN MATERIALS THAT WERE USED TO SOLICIT JUNK BOND PURCHASERS, THE RAIDERS' PLAN FOR UNOCAL. THE JANUARY HARPERS MAGAZINE ARTICLE, "THE BIGGEST KNOCKOVER," SHOWS THAT THE SAME SCHEME DROVE GULF OIL TO THE SLAUGHTER. I WON'T GO INTO THE DETAILS, WHICH WERE INCLUDED IN MESA'S AMENDED S.E.C. FILING OF MAY 2, OTHER THAN TO NOTE THE ABSURD NATURE OF THE PROPOSED CAPITALIZATION AFTER THEY SOMEHOW MANAGED THE MERGER BETWEEN UNOCAL AND "NEWCO" -- THE MESA SHELL COMPANY INVENTED SOLELY FOR THIS PURPOSE.

BEFORE THAT PROPOSED MERGER, UNOCAL'S EQUITY WAS $5.7 BILLION, AND OUR LONG-TERM DEBT, $1.3 BILLION. AFTER THE MERGER, THE COMBINED COMPANIES WOULD HAVE HAD $1.3 BILLION IN OLD LONG-TERM DEBT; $864 MILLION IN "INDEBTEDNESS USED TO REPAY BACK DEBT OF AFFILIATES"; $2.4 BILLION IN SERIES A, B, AND SENIOR SUBORDINATED NOTES; $1.9 BILLION IN JUNIOR PREFERRED STOCK; AND $4.7 BILLION IN SUBORDINATED NOTES AND PREFERRED STOCK TO BE ISSUED IN THE MERGER -- THE "BACK-END JUNK," AS WALL STREET CALLS IT, TO BE FORCED ON THE REMAINING UNOCAL SHAREHOLDERS. FINALLY, TO SUPPORT THIS PYRAMID OF NEARLY $11 BILLION OF DEBT, $10 MILLION OF NEWCO COMMON STOCK!
THAT'S QUITE A HIGHWIRE ACT -- OUTPERFORMING ANYTHING CONCEIVED BEFORE THE 1929 CRASH! AND IF IT ISN'T SOME KIND OF VIOLATION OF THE CREDIT MARGIN RULES, THEN WE'VE LOST BOTH COMMON SENSE AND ANY REASON TO BELIEVE IN THE JUST AND FAIR ADMINISTRATION OF THE NATION'S LAWS.

PERHAPS OUR RECENT CLASH WAS INEVITABLE. WE TRY TO BUILD, THESE RAIDERS SEEK TO DESTROY. OUR CONTINUED SUCCESS MUST HAVE MADE THEM THINK WE WERE FAT, DUMB AND HAPPY. THEY KEPT PICKING

OFF VICTIMS, AND HEADING OUR WAY; AND WALL STREET WAS JUST WAITING FOR THE SHOOTOUT.

WE DIDN'T WAIT. IN 1983, WE REINCORPORATED IN DELAWARE, ESTABLISHED STAGGERED TERMS FOR MEMBERS OF OUR BOARD OF DIRECTORS, AND PROVIDED OTHER BOARD AUTHORITY THROUGH BYLAW CHANGES. WE EXPLAINED TO OUR SHAREOWNERS WHY WE FELT THOSE CHANGES WERE NECESSARY, ASKED THEIR APPROVAL, AND THEY BACKED US BY A LARGE MARGIN IN OUR PROXY VOTE.
THEN, LAST YEAR, WE BEGAN TO STUDY RAIDERS' TECHNIQUES MORE CLOSELY AND TO CONSIDER VARIOUS DEFENSIVE STRATEGIES. THE SHOWDOWN BEGAN WITH THE FEBRUARY 14 ANNOUNCEMENT OF MESA'S "INVESTMENT" IN UNOCAL, FOLLOWED BY A PROXY CONTEST TO DELAY OUR ANNUAL MEETING AND A $54 PER SHARE TWO-TIER TENDER OFFER FOR 50-PLUS PERCENT OF OUR SHARES.

AFTER REVIEWING THESE MANEUVERS, THE JUDGE IN OUR FEDERAL COURT ACTION IN CALIFORNIA FOUND THAT MESA WAS SEEKING TO PROFIT THROUGH EITHER ACQUISITION AND BUST-UP OF UNOCAL OR THROUGH GREENMAIL.

WE WERE IN A TWO-FRONT WAR -- PROXY FIGHT AND TENDER OFFER -- BUT WE WERE READY. WE HAD ALREADY DECIDED NOT TO FOLLOW THE EXAMPLE OF MOST COMPANIES THAT HAD FOUGHT SUCH BATTLES. RATHER THAN TURN OUR DEFENSE OVER TO ONE NEW YORK LAW FIRM OR INVESTMENT BANKING FIRM AS MOST OTHERS HAD DONE, WE ESTABLISHED OUR OWN INSIDE DEFENSE TEAM. WE THEN PICKED TWO FINANCIAL ADVISORS, AN OUTSIDE PUBLIC RELATIONS FIRM, ONE PROXY SOLICITATION COMPANY AND SEVERAL OF THE NATION'S BEST LAW FIRMS TO HANDLE SPECIFIC ASPECTS OF OUR DEFENSE.

THE MEMBERS OF OUR OUTSIDE TEAM SUBMITTED IDEAS AND PROPOSALS, BUT OUR EXECUTIVE COMMITTEE AND BOARD OF DIRECTORS CALLED THE SHOTS. THEN THE ENTIRE TEAM, INCLUDING UNOCAL'S OWN LOYAL EMPLOYEES, IMPLEMENTED THE STRATEGY AND CARRIED IT THROUGH.

THE KEY SHOT CAME ON APRIL 15. MESA'S TENDER OFFER HAD BEEN DESIGNED TO PURCHASE HALF THE COMPANY AT AN INADEQUATE CASH PRICE AND TO CONVERT THE SECOND HALF OF THE SHARES TO DEEPLY SUBORDINATED DEBT SECURITIES. OUR BOARD COUNTERED WITH A CONDITIONAL BACK-END TENDER TO BUY SOME 49 PERCENT OF OUR SHARES AT $72 A SHARE -- IF MESA'S OFFER SUCCEEDED -- AND TO PROTECT OUR NON-MESA SHAREHOLDERS BY SPECIFICALLY EXCLUDING MESA AS A PARTICIPANT.

BY THIS STRATEGY WE SOUGHT TO DISCOURAGE THE MESA OFFER AND TO PROVIDE SHAREHOLDERS WITH AN ALTERNATIVE -- THE OPPORTUNITY TO EXCHANGE A PORTION OF THEIR SHARES FOR A FAIR VALUE.
AFTER A SERIES OF COURT BATTLES, ON MAY 17 THE DELAWARE SUPREME COURT RULED THAT THE BOARD COULD PROPERLY EXCLUDE A RAIDER. PLEASE LET ME STRESS THAT THE RULING DOES NOT GIVE BLANKET APPROVAL TO ANY PARTICULAR STRATEGY OR TACTIC -- TO A "DRACONIAN MANEUVER," AS THE COURT PUT IT. NOR DOES IT DISCOURAGE ADEQUATE TENDER OFFERS -- EVEN HOSTILE ONES. BUT THE RULING DOES GIVE A BOARD OF DIRECTORS THE AUTHORITY TO ACT

TO PROTECT THE INTERESTS OF THE REMAINING SHAREHOLDERS IF, IN ITS OPINION, ONE OR MORE SHAREHOLDERS IS ACTING LIKE A PREDATOR -- AS IN OUR CASE, TRYING TO GRAB CONTROL OF THE COMPANY AT SUBSTANTIALLY LESS THAN TRUE VALUE.
WE ARE CONFIDENT THAT ANYONE WHO STUDIES THE FACTS OF THIS CASE WILL AGREE THAT THE DELAWARE SUPREME COURT RULED PROPERLY. MESA'S HOSTILE TENDER WAS A COERCIVE, TWO-TIER, FRONT-END LOADED OFFER AT A GROSSLY INADEQUATE PRICE. IF IT HAD BEEN SUCCESSFUL, MOST OF UNOCAL'S SHAREHOLDERS, WITH APPROXIMATELY HALF THE SHARES OUTSTANDING, WOULD HAVE BEEN FORCED TO EXCHANGE THEIR SHARES FOR "BACK-END JUNK" (TO USE THE WALL STREET TERM). ON THE OTHER HAND, OUR BACK-END EXCHANGE OFFER FOR $72 PER SHARE IN NOTES WAS A MEASURED RESPONSE TAILORED TO PREVENT THAT ABUSIVE DEAL.

FURTHER, A SPECIFIC SET OF CONDITIONS WAS MET IN THIS CASE. WE HAD TO PROVE TO THE COURT THAT OUR DIRECTORS' PRIMARY MOTIVE WAS TO PROTECT SHAREHOLDERS, NOT TO FURTHER PERSONAL INTEREST; THAT THE BOARD'S ACTIONS WERE BASED UPON "REASONABLE INVESTIGATION"; THAT EXCLUSION OF THE RAIDER FROM OUR OFFER WAS A REASONABLE RESPONSE TO THE SPECIFIC THREAT POSED TO STOCKHOLDERS; AND THAT THE BACK-END PRICE WE OFFERED WAS REASONABLE, AND NOT SOME HIGH-PRICED POISON PILL.
WE MET EACH AND EVERY ONE OF THOSE TESTS. THE COURT DECISION IS BOTH LOGICAL AND JUST. IT RECOGNIZES THE COERCIVE AND INEQUITABLE NATURE OF JUNK-FINANCED RAIDS AND WORKS TO PROTECT SHAREHOLDERS FROM SUCH TWISTS AND DECEIT.

IF A HOSTILE TENDER OFFER IS MADE AT AN APPROPRIATE PRICE, GIVING SHAREHOLDERS FAIR VALUE FOR THEIR STOCK, AND IF IT IS NOT DESIGNED TO SQUEEZE OUT 49% OF THE SHAREHOLDERS BY FORCING THEM TO EXCHANGE THEIR SHARES FOR DEBT SECURITIES OF DUBIOUS VALUE, A SELF-TENDER SUCH AS OURS WOULD NOT GARNER THE SUPPORT OF THE SHAREHOLDERS.

AND, IN FACT, OUR TENDER OFFER WAS FULLY AND ENTHUSIASTICALLY SUBSCRIBED, AND WE WILL PRO-RATE AT ABOUT 39 PERCENT. OUR SIMULTANEOUS PROXY FIGHT ENDED WITH OUR MANAGEMENT WINNING BY ABOUT A 2 to 1 MARGIN OVERALL, AND ABOUT 8 to 1 ON THE VOTE OF OUR INDIVIDUAL SHAREHOLDERS.
I MENTION ALL THIS, MR. CHAIRMAN, BECAUSE SOME REGULATORS HAVE EXPRESSED "DISMAY" ABOUT THE DELAWARE DECISION. THEY ARE NOW WORKING ON A RULE TO PREVENT SIMILAR CASES IN THE FUTURE. IF THEY HAD ONLY DONE THEIR JOBS IN THE FIRST PLACE, I DOUBT THAT THIS CASE WOULD EVER HAVE GONE TO COURT.

IN FACT, THE THING I HAVE FOUND MOST FRUSTRATING DURING THESE RECENT CORPORATE RAIDS IS THAT THE REGULATORY AGENCIES DO NOTHING TO ENFORCE THE LAWS AND THEIR OWN RULES. AS A RESULT, RAIDERS SEE THEM AS PAPER TIGERS; AND SOME RAIDERS SEEM TO HAVE BECOME COLLECTORS OF S.E.C. CONSENT DECREES WHILE THEY COLLECTED MILLIONS OF GREENMAIL DOLLARS. I AM SUBMITTING FOR YOUR INFORMATION COPIES OF AN ARTICLE FROM THE AMERICAN LAWYER THAT DISCUSSES THIS DISGRACEFUL REGULATORY SYNDROME.
TODAY, THE PLAYING FIELD IN THE CORPORATE TAKEOVER GAME HAS BEEN LEVELLED TO SOME EXTENT; NOT SURPRISINGLY, WE NOW HEAR

GROANS OF ANGUISH FROM THE RAIDERS AND THEIR SUPPORT TEAMS WHO PREVIOUSLY HAD THE RULES -- AND THE PROFITS -- GOING THEIR WAY. BUT, DESPITE THEIR PROTESTS, THIS RULING DOES NOTHING TO DETER ADEQUATE OFFERS THAT GIVE SHAREHOLDERS FAIR VALUE (WHETHER OR NOT THOSE OFFERS ARE "HOSTILE").

FOLLOWING THIS DECISION, WE COULD NEGOTIATE A SETTLEMENT ON EQUAL FOOTING. AFTER TWO DAYS OF MEETINGS, WE REACHED AN AGREEMENT ON MAY 20. IN RETURN FOR THE RIGHT TO PARTICIPATE IN A LIMITED PORTION OF OUR SHARE EXCHANGE, THE MESA GROUP -- ALONG WITH ITS FINANCIAL BACKERS, DREXEL BURNHAM LAMBERT, INC. -- AGREED TO CEASE IMMEDIATELY ALL EFFORTS TO TAKE CONTROL OF UNOCAL OR OTHERWISE INFLUENCE OUR POLICIES OR AFFAIRS. MESA MAY NOT BUY ANY NEW SHARES OF UNOCAL STOCK FOR 25 YEARS, AND THE SHARES IT CURRENTLY OWNS MUST BE SOLD UNDER CAREFULLY CONTROLLED CONDITIONS. IN ADDITION, DREXEL BURNHAM WILL NOT BUY OR FINANCE THE PURCHASE OF ANY UNOCAL SHARES FOR THE NEXT THREE YEARS, EXCEPT IN THE ORDINARY COURSE OF ITS BROKERAGE ACTIVITIES.

OUR SETTLEMENT INVOLVED NO GREENMAIL. NOR DID WE PAY A SINGLE PENNY OF MESA'S "EXPENSES" -- OFTEN THE DEVICE BY WHICH GREENMAIL PAYMENTS ARE DISGUISED SO THAT THE RAIDERS' SELF-RIGHTEOUS EXPRESSIONS CAN CONTINUE, THEIR PROFITS CAN BE GIVEN FAVORED TAX TREATMENT, AND (PERHAPS) THE PUBLIC CAN BE DECEIVED. MESA WILL END UP LOSING MONEY ON ITS UNOCAL ADVENTURE.
I'M CONVINCED WE WON THIS VICIOUS BATTLE BECAUSE WE HAD A HIGHLY TALENTED TEAM -- FULLY BACKED BY A STRONG BOARD OF DIRECTORS -- WORKING ON A CAUSE THAT WE ALL KNEW WAS JUST: PROTECTING THE RIGHTS OF OUR SHAREOWNERS AND OUR EMPLOYEES, WHO COMPRISE ONE OF OUR LARGEST GROUPS OF SHAREHOLDERS.

IF OUR INNOVATIVE AND SPIRITED DEFENSE PROVES RESPONSIBLE FOR BRINGING THIS CURRENT TAKEOVER WAVE TO A HALT OR EVEN SLOWING IT DOWN, AS SOME ARE NOW SAYING -- THEN ALL THE MISERY OF THE LAST THREE MONTHS WILL BE WORTH IT.

ALTHOUGH WE HAVE FOUGHT THROUGH OUR TAKEOVER CRISIS, OTHER COMPANIES ARE NOW ON THE FIRING LINE. WHAT SHOULD THE ADMINISTRATION, THE CONGRESS, THE COURTS AND VARIOUS REGULATORY AGENCIES DO ABOUT THESE UNPRODUCTIVE, HIGHLY SPECULATIVE RAIDS? I RECOMMEND THE FOLLOWING 10-STEP PROGRAM:

1) THE MOST URGENT NEED IS FOR A LEGISLATED MORATORIUM ON HOSTILE TAKEOVERS -- A SORT OF COOLING-OFF PERIOD -- WHILE CONGRESS SORTS OUT THE ISSUES AND TAKES THE NECESSARY CORRECTIVE STEPS.

2) THE S.E.C. AND OTHER REGULATORY AGENCIES SHOULD TAKE STEPS TO MAKE THEIR INVESTIGATIONS TIMELY AND SERIOUS. THEY SHOULD IMPOSE REAL SANCTIONS RATHER THAN WRIST-SLAPS WHEN THE SITUATION DEMANDS. PERHAPS CONGRESSMAN JOHN DINGELL'S, RECENT REQUEST TO THE S.E.C. FOR A FULL RECORD OF ENFORCEMENT INFORMATION WILL SPARK SOME INTEREST AMONG BOTH RAIDERS AND REGULATORS.

3) THE FEDERAL RESERVE BOARD SHOULD EXAMINE THE FINANCIAL BACKING FOR THESE RAIDS. FOR INSTANCE, A PRIVATE INDIVIDUAL CAN ONLY "MARGIN" (BORROW TO BUY) 50 PERCENT OF THE COST OF A STOCK PURCHASE; BUT THE RAIDERS BORROW OR RECEIVE "COMMITMENTS" FOR VIRTUALLY 100 PERCENT OF THE COST OF A RAID. THE FEDERAL RESERVE BOARD'S MARGIN RULES SHOULD BE CLARIFIED, AND ENFORCED.

4) THE RULES COVERING ANNOUNCEMENT OF STOCK OWNERSHIP AND INTENTION SHOULD BE CHANGED, CLOSING THE 10-DAY "WINDOW" AFTER THE 5 PERCENT THRESHOLD HAS BEEN REACHED. THE ONLY PURPOSE THAT "WINDOW" NOW SERVES IS TO ALLOW THE RAIDERS TO BUY MORE SHARES WITHOUT PUBLIC KNOWLEDGE.

5) THERE SHOULD BE ACTION TO PREVENT THE CURRENT RAIDER PRACTICE OF ANNOUNCING A TENDER OFFER BEFORE THE FINANCING IS ARRANGED AND ALL THE NECESSARY LOAN COMMITMENTS HAVE BEEN SIGNED. THE CURRENT SYSTEM IS VIRTUAL EXTORTION. IT ALLOWS RAIDERS TO ISSUE THREATS RATHER THAN FINANCE LOANS; IT SAVES THEM FROM MAKING ALL NECESSARY LOAN COMMITMENTS, AND THUS SAVES THEM FEES AND INTEREST THAT THEY SHOULD HAVE AT RISK IF THEY ARE SERIOUS ABOUT THEIR SO-CALLED TAKEOVER BID. IT MAY ALSO MEAN THAT SOME "COMMITMENTS" ARE MADE THAT CANNOT BE BACKED; BUT THE THREAT CAN STILL SEEM VERY REAL.

6) STATE AND FEDERAL REGULATORY AGENCIES SHOULD EXAMINE THE PRACTICES OF PENSION FUNDS, INSURANCE COMPANIES, AND SOME BANKS AND SAVINGS AND LOANS THAT INVEST THEIR CLIENTS' MONEY IN THE HIGH-RISK, "TAKEOVER JUNK" BONDS THAT SUPPORT THESE HOSTILE RAIDS. OUR FINANCIAL INSTITUTIONS SHOULD CONCENTRATE ON LOANS THAT CREATE JOBS AND ADD TO THE NATION'S REAL OUTPUT, NOT ON LOANS THAT FUEL THE SPECULATOR AND THE TAKEOVER ARTIST. SINCE MANY OF THOSE FINANCIAL INSTITUTIONS ARE INSURED BY GOVERNMENT AGENCIES, THE TAXPAYERS ARE ASSUMING THE RISK FOR THESE RAIDER SCHEMES; YET WE REAP NO BENEFIT FROM THESE RAIDING SCHEMES -- IN FACT, WE ARE DAMAGED BY THEM.

7) THE RULES GOVERNING TENDER OFFERS SHOULD BE MODIFIED TO GIVE THE TARGET COMPANY AN ADEQUATE TIME TO EVALUATE THE PROPOSAL AND TO PREPARE COUNTERACTION IF WARRANTED. I CAN ATTEST FROM PERSONAL EXPERIENCE THAT THE PRESENT TWENTY BUSINESS DAYS IS WOEFULLY SHORT; SIXTY BUSINESS DAYS WOULD BE MORE APPROPRIATE.

8) CONGRESS SHOULD PROHIBIT TWO-TIER TENDER OFFERS. NO SHAREHOLDER IN A TARGET COMPANY SHOULD BE COERCED INTO TENDERING QUICKLY FOR AN INADEQUATE PRICE SIMPLY TO ESCAPE BEING BURIED UNDER BACK-END JUNK.

9) RELATED TO THAT SAME POINT, ANY HOSTILE RAIDER WHO ACQUIRES OVER, SAY, 20 PERCENT OF A COMPANY'S STOCK SHOULD BE REQUIRED TO OFFER FOR 100 PERCENT AT ONE PRICE -- UNLESS THE COMPANY'S BOARD OF DIRECTORS APPROVES SOME OTHER ARRANGEMENT.

10) MY FINAL CONCERN LIES OUTSIDE OF THE JURISDICTION OF THIS COMMITTEE, BUT SHOULD BE CONSIDERED BY CONGRESS -- THE PRESENT TAX SYSTEM FAVORS DEBT OVER EQUITY, THE RAIDER OVER THE DEFENDER, THE SHORT TERM OVER THE LONG TERM. IT FAVORS THE RAIDER BY PERMITTING THE DEDUCTION OF INTEREST ON BORROWED MONEY USED FOR CORPORATE TAKEOVERS, AND IN THE WAY RAIDERS CAN REPORT "EXPENSES." AS A RESULT, FEDERAL REVENUES ARE LOWER AND AMERICAN TAXPAYERS SUBSIDIZE PART OF THE CORPORATE-TAKEOVER GAME. THIS IS NOT FREE ENTERPRISE, AND IT IS NOTHING THAT SHOULD CONTINUE.

IN ADDITION, THERE SHOULD BE PUNITIVE TAXES TO END "GREENMAIL" -- LEGAL BLACKMAIL BY WHICH COMPANIES BUY BACK A RAIDER'S STOCK HOLDING AT A PREMIUM, TO THE DETRIMENT OF OTHER SHAREHOLDERS. THIS MAY BE DIFFICULT, BECAUSE GREENMAIL COMES IN MANY DISGUISES. BUT CONGRESS SHOULD TRY TO END IT.

THESE AND OTHER THINGS MUST BE DONE, AND QUICKLY. THE AMERICAN ECONOMY NEEDS STRONG, PRODUCTIVE COMPANIES TO HELP FUEL ITS LONG-TERM GROWTH. THE RAIDERS ARE WORKING NOT FOR AMERICA'S BEST INTERESTS, BUT ONLY FOR THEIR OWN.

THANK YOU.

THE BIGGEST KNOCKOVER

T. Boone Pickens and the end of Gulf Oil

By L. J. Davis

NEW YORK. *The Regency Hotel.*
June 5, 1984.

As the long New York summer began in a steam bath of humidity and drenching gusts of rain, the stock brokerage firm of Spear, Leeds & Kellogg gave a dinner at the Regency Hotel on Park Avenue. Present were some sixty arbitrageurs ("arbs," to each other), specialists in the deceptively simple art of buying certain securities low—when, say, information reaches them that a merger or an acquisition is under way—and selling them high. No man there knew what the morrow might bring (the arbs would have given much for the information), but at the moment they had much to be grateful for. They were gathered to celebrate a famous victory and to honor the man who had brought it about, making them all substantial sums of money. Their guest was T. Boone Pickens Jr., fifty-six, the chairman, president, and chief executive officer of the Mesa Petroleum Company of Amarillo, Texas. His feat was simple and astonishing: three months earlier he had driven the Gulf Oil Company out of existence.

On March 5, 1984, James E. Lee, the chairman of Gulf Oil, had finally acknowledged the obvious and submitted to the inevitable. His company had accepted a $13.2 billion takeover bid from the Standard Oil Company of California (Socal)—no thanks whatever to Pickens, whose raid on Gulf's stock during the previous eight months had brought them all to that fascinating moment. It was the largest merger in U.S. corporate history: the nation's fifth largest oil company, Gulf, would combine with the fourth largest, Socal, to form the third largest. Gulf would not survive, but Pickens and his allies—defeated, foiled, decisively trounced—would never sit on Gulf's board or occupy its executive suite. They would, however—although Lee could not find it in himself to say so—walk away with more than three quarters of a billion dollars.

At the Regency, the mayor of New York, Edward Koch, presented Pickens with a crystal apple in token of the vast and unprecedented fees the Amarillo oilman had brought to the city's financial community and, indirectly, through various forms of taxation, to its municipal coffers. Pickens was a man accustomed to singing for his supper, and he had come prepared. He produced a live monkey.

"I'd like you people to meet Jimmy Lee," he said.

NEW YORK. *The Union League Club.*
September 16, 1983.

It was the Friday morning before Yom Kippur when Larry Rand received a call from a banker in the mergers and acquisitions department of Salomon Brothers, the investment bankers. Could Rand, the banker asked, meet with some people from Gulf Oil, an important Salomon client, that noon at the Union League Club? Rand's schedule was tight; with the Holy Days coming, he planned to be home before sundown, and the atmosphere at the venerable old club was rarely conducive to haste. "They think," said the banker, "that they've got a Boone Pickens problem." Rand said he'd be right over.

There had been indications, of course. On

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Larry Rand knew how Pickens operated, but he also knew a few things about Gulf. 'You people,' he warned, 'have a terrible reputation on Wall Street'

September 2, and again on September 15, Dan Dorfman reported in his syndicated column that Wall Street rumors had Mesa buying and holding—taking a position in, in Wall Street parlance—Gulf stock; talk on the Street had Pickens controlling stock that amounted to between 1.5 and 2 percent of the company. Pickens and his broker, Allan ("Ace") Greenberg, of the New York brokerage firm of Bear, Stearns & Company, denied everything. ("My point of view is that if somebody asks you a question he shouldn't ask, you have every right to tell him a lie," Greenberg later explained.) About the same time, both the equity department at Salomon Brothers and Gulf's own financial people detected unusual trading activity in Gulf stock. Somebody was buying a lot of it, and Gulf was not long in deciding who that somebody was.

Larry Rand is director and senior vice president of Kekst and Company, a firm that specializes in corporate public relations. He is not the person a company normally calls the moment its stock becomes the subject of a raid. But Rand possessed unique knowledge: he and his senior partner, Gershon Kekst, had encountered Boone Pickens before, most recently at KN Energy, a Colorado-based natural gas and pipeline company that, it was widely believed, Pickens was even now subjecting to a so-called greenmail raid. In a greenmail raid, a speculator assumes a powerful position in a company's stock (that is, he buys quite a lot of it); then lets it be known (or, if he is clever, allows the company's management to assume over his strenuous but purposely unconvincing denials) that he is planning an unfriendly takeover that will involve a purge of the executive suite; then allows himself to be bought out at a handsome premium by the officers thus panicked.

Pickens was believed to be a master of this lively but difficult art, and Rand seemed just the person to describe Pickens's method of operation. Rand was more than willing to do so, but he had another message for Gulf. "You people," he warned, "have a terrible reputation on Wall Street."

By a curious coincidence, this reputation stemmed directly from some previous activities involving not only Gulf but Pickens. Like Rand, Gulf had met Pickens before, although the experience seemed to have taught Gulf little. During the summer of 1982, Pickens had made his first big takeover bid, tendering for the stock of the Cities Service Company, the nineteenth largest oil company in the United States. In a complex and nasty little battle, Cities drove away his co-investors (Pickens was attempting to conduct a raid with partners, a first) and almost succeeded in buying Mesa Petroleum out from under Pickens's feet. But in the end it was Cities, not Mesa, that went to the wall. Baffled at every turn by the almost insanely nimble Pickens, Cities was forced to seek safe harbor in the form of a corporate savior, a larger and friendlier company that would top Pickens's bid. On Wall Street, such a company is called a white knight. Cities' white knight was Gulf Oil.

By coming to the rescue of Cities, Gulf actually saved Mesa—and guaranteed Pickens an after-tax profit of $12.7 million when it bought back at a premium the Cities securities Mesa held. But for Cities, Gulf proved less a white knight than a broken reed. Confronted by Federal Trade Commission antitrust objections—objections many observers considered trivial, the oil industry is not a concentrated one—Gulf, with no warning, bailed out of the deal. Gulf's withdrawal left a great many arbs (and a great many amateur investors in search of a killing) holding a great many Cities Service securities whose price had suddenly if not surprisingly collapsed. It is doubtful that Charles J. Waidelich, Cities chairman, and the durable Dr. Armand Hammer, chairman of Occidental Petroleum, saved Wall Street and with it Western civilization, as some claimed, when they quickly moved to fold Cities into Oxy. But at least they were able to hold the arbs' losses to around $400 million—a figure that, understandably, burned its way into the arbs' collective memory. No arb likes to be caught holding the bag, and the bag in question was a particularly capacious one.

If Pickens were indeed making a run at Gulf, as Larry Rand at least half suspected, the arbs would be likely to pour their abundant resources into Gulf stock with even more than their usual enthusiasm, creating a perilously unstable situation. Moreover, much of Gulf's stock was held by large institutional investors—pension and mutual funds—which were loyal enough when the market was placid, but the responsibilities of which were fiduciary in nature. The primary responsibility of any fiduciary institution is to protect the money placed in its custody; if Pickens introduced enough volatility into Gulf's stock—if he, in the argot of Wall Street, put the stock in play—the institutions would probably dump their holdings. And if the arbs picked them up, and if Pickens played his hand cleverly, and if Gulf's defense lacked spunk and imagination, Gulf could be destroyed as an independent company. There was great danger here.

This, then, was the meaning of Larry Rand's warning. For all intents and purposes, the men from Gulf ignored it. They were much more interested in Pickens himself. If they could only

figure out who the hell he was, they reasoned, they might be able to deduce what the hell he was up to.

There was little to go on. Pickens was born in Oklahoma, and he liked conservative suits. It was known that he was a Presbyterian elder and it was suspected that he was a pest. He was a very conservative Republican who had once voted for Lyndon Johnson, a staunch believer in physical fitness who had been known to take a drink. A onetime geologist with the Phillips Petroleum Company, he had founded the forerunner of Mesa at the age of twenty-seven with $3,500 in cash.

Located in the deserted heart of downtown Amarillo, a city whose streets appear to have been vented by a perfected version of the tornado bomb, Mesa was as close an analogue to the furnishings of Pickens's mind as Gulf was likely to find. But an exploration of the company revealed little that was useful beyond the fact that it is a taut ship with a mildly eccentric captain. No tobacco is visible during office hours—Pickens detests smoking in all its forms. Nor does Pickens approve of office romances, even if the partners are unmarried. The showplace of the Mesa suite is the executive building at One Mesa Square in the T. Boone Pickens Jr. Fitness Center, equipped with a jogging track, a weight room, and a bruise of racquetball courts. Racquetball is Pickens's favorite game. The fitness center is dominated by a statue of its founder, encased in the sport. "I always tell our new young executives—we're in our middle or a youth movement here—how I feel about exercise and good health," he said one day last spring, "and during their orientation period I make a point of telling them about the programs we offer and the story I tell is them. You know, I find that close to 120 percent sign up."

He is an equally keen fan of the speaker phone, with similarly apostolic results. Every qualified executive not only has one but uses it constantly, so that a stroll through headquarters during office hours is a little like a visit to a college dormitory during finals week, when everybody—for reasons that can only be imagined—has decided to play old Bob Newhart records.

Although Pickens had recently been presenting himself as a champion of shareholder rights (of which, more in a minute), Mesa itself had been rendered as impervious to the unwelcome initiatives of its own legal owners as human ingenuity could make it. The company was incorporated in Delaware, a state whose laws are unmarked by a foolish sympathy for stockholders. Mesa's directors, like United States senators, serve staggered terms, making it impossible to overthrow the board at a single annual meeting. In addition, there are certain circumstances when a simple majority is not enough to pass a resolution; Mesa's bylaws stipulate that only a "supermajority" (75 percent) of the voting stock can carry the day. (Pickens professes to loathe the supermajorities of others.)

These measures are a serious barrier to mischief making among Mesa's ordinary shareholders, of course, but that is not their primary purpose. They are, in fact, defensive measures—walls built between Mesa and ambitious outsiders. Mesa is a very, very difficult company to raid. But even if a successful raid were to occur, Pickens would be ready. Many executives, fearing or anticipating attack, arrange employment contracts for themselves, ensuring that they, like certain baseball players, receive a handsome salary for years after being dismissed in the business world; these are known as golden parachutes, and Pickens has been lauded in his denunciation of them. But he has a golden parachute of his own.

The foundation of Mesa's business is its stake in the great Hugoton gas field north of Amarillo. In the language of the oil patch, Mesa is an "upstream" company, confining its activities to exploration, drilling, and production. Unlike Gulf and other "integrated" oil companies, Mesa has none of the money-losing "downstream" operations—the refineries, the chemical and plastics plants, the tankers and pipelines and service stations—that, in the time of cheap energy and abundant supplies, were necessary (or so it was thought) to absorb the flow of "feedstock" from the wells. Pickens does not believe in downstream operations.

Over the years another conviction had taken form in his mind. In the United States, Pickens believes, petroleum bonanzas are a thing of the past. It is true that Mesa has consistently replaced its reserves—oil in the ground, as distinct from oil in storage. And it is undeniable that Mesa has made him a rich man. (In 1985, Pickens was the highest-paid executive in the country, with a before-tax income of $7,866,000.) But by the late 1970s he was certain that Mesa would never strike the equivalent of the East Texas field that had made his friends in the Hunt family wealthy beyond the dreams of avarice. Plenty of oil remained in the world, but it lay either in huge fields abroad that were at the mercy of radical and unreliable foreigners or in the so-called frontier areas of the United States—Alaska and the outer continental shelf—where drilling costs, Pickens insisted, were prohibitive and exploration a mug's game, however loudly Gulf and the other majors professed to believe otherwise.

In Pickens's view, the oil business in the

The men at Gulf were more interested in Pickens himself than in his moves. If only they could figure out who the hell he was

United States was not set played out but it was gradually winding down, and there seemed to be ample proof that this was so, with the exception of well-managed Shell, the major oil companies had consistently failed to replace their domestic feedstock with new discoveries, and their American reserves were therefore a sinking asset, one that was in the process of disappearing. Pickens believed the time had come for oilmen to find new ways of making money, but he did not believe they had to leave the oil business to do so. He had already tried that once. In 1974, Mesa sold off its cattle business, the only non-petroleum subsidiary it had ever owned, at a $19 million loss. Pickens never diversified again.

T. Boone Pickens

There was no secret about his views; Pickens was a popular and eloquent after-dinner speaker, and unlike many corporate executives, he was adept at airing his opinions in the press. Nor was there any secret about his sole contribution to the science of practical economics; the investment community had fairly trumpeted his activities from the rooftops. Like all seminal ideas, Pickens's great discovery was based on a perception that was obvious, simple, and completely overlooked by everyone else. If major oil companies like Gulf were indeed depleting their reserves for cash—that is, liquidating their assets—they should acknowledge the fact. Rather than spending (squandering, Pickens would argue) that cash on, say, unprofitable downstream operations, the oil executives should be placing the money in the hands of their companies' legal owners, the stockholders. There was an obvious method of doing so, with implications that were pleasing. When a company is liquidated in the usual way, through bankruptcy, a trustee is appointed to oversee the distribution of its assets to its creditors and (if anything is left) to its stockholders. Under the ancient law of trusts, these assets first pass into the legal ownership of the trustee. Here a number of bright possibilities present themselves. For a trust is obviously not the same thing as a corporation. In fact, in certain ways it is a better thing. If an oil company transferred its wells to a trustee, the income from those wells would no longer be subject to corporate income tax. Under a trust, moreover, all of the income from the divested wells would be distributed to the stockholders rather than enter the company's cash stream, there to be spent (in Pickens's view) neither wisely nor well.

There would be an additional benefit, an important one. For years, the stock market has recognized that something is seriously amiss at the oil majors, even if the relevant companies have not. Because of this perception, the market has chronically undervalued the stock of almost every oil company, including Mesa, pegging the price of shares to the amount of the annual dividend rather than to a company's liquidation value, that is, the actual value of its assets. But if a company, or a portion of one, were undergoing formal liquidation through a trust, it would seem likely that the market would value the shares and trust certificates at a

level that more closely resembled the company's true worth, presenting the stockholders with a potential windfall through the run-up in the price of their stock.

There was only one way to find out. In the broad light of day on November 1, 1979, Pickens created the Mesa Royalty Trust and poured into it properties representing half of Mesa's proven reserves, with estimated net future earnings of a billion dollars. Each Mesa stockholder received a unit of the trust for every share owned on the day of record, while Mesa itself retained 10 percent of the units.* As Pickens had predicted, the price of what had once been a single share of Mesa Petroleum—which was now a share of Mesa plus a unit of the trust—took off into the ionosphere. In July 1979, four months before the trust was established, Mesa was trading at around $40 a share on the New York Stock Exchange. By mid-January 1980, two months after the spinoff of the trust, Mesa was trading near $60 a share and a unit of the trust was fetching about $35. Two years later, after a pair of two-for-one stock splits and a series of giddy plunges in oil shares that marked the end of the OPEC-inspired petroleum bull market, Mesa still traded at around 17¼ (for a pre-split valuation of 69), while the trust units fluctuated between 19½ and 40⅛. Mesa stockholders had done well by the trust spinoff. Having retained 10 percent of the trust, Mesa itself was as happy as the other stockholders, moreover, a substantial portion of its corporate tax disappeared. It was impossible, of course, but it appeared that Boone Pickens had proved that two minus one equals four.

Gulf, like the other majors, had observed the situation, studied the concept, and rejected it. The money generated by its wells was badly needed to feed its huge, deficit-ridden downstream; every penny was precious. To this, Pickens would later have a simple reply: if a downstream loses money, get rid of it. But to a company like Gulf, the notion of growing significantly smaller was unthinkable.

Creating the trust had been an illuminating and instructive experience for T. Boone Pickens, and perhaps it would also prove to be a useful one. The world of corporate capitalism was an exotic place in the early 1980s, a field of sport and prizes. Pickens was looking for bigger game. In the popular mind (although he denied it), he was about to join the company of Bill Agee, Victor Posner, Saul Steinberg, and Rupert Murdoch. In the popular mind (although he denied it), he was about to become a corporate raider, a man who laid waste to the corporate landscape by inspiring terror.

There are two legal ways of making a great deal of money in the sort of capitalism that succeeded the Industrial Revolution. The officially preferred and more morally acceptable method consists of concocting a superior mousetrap, whereupon the world beats a path to the inventor's door, and he becomes rich. While the social utility of, say, Cabbage Patch Kids, ghetto-blaster radios, and telephones that play board games is doubtless a question that will murder the sleep of archaeologists yet unborn, this is capitalism at, presumably, its noblest.

The other, much simpler method consists of buying the stock of a carefully selected, publicly traded company and fiddling with the shares in one or more of a variety of creative ways. While this activity, for reasons that are more subjective than rational, has often been considered morally reprehensible, it is based on a fact of life that is remarkably uncomplicated. Ace Greenberg, Pickens's broker, once explained it this way: if a person labors for twenty years to build a house, and then proceeds to sell the place, he can't live there anymore. Shares of stock represent fragments of ownership in a company, a fact often forgotten. If someone buys enough of them, he can demand the key to the front door.

Although the public—or at least the press—has professed to be taken by surprise, there is nothing surprising about the corporate hubbub and the bold, lightning strokes of the 1980s; the floor of the stock exchange has historically been an exciting place. It is true that there had been a fifty-year lull during which the most creative speculators worked their colorful magic quietly or not at all, but this curious period of peace was due less to the reforms of the New Deal or the emergence of a new and altruistic breed of investor than to another pair of easily discernible circumstances. During the Depression and World War II, there was nothing much for the stock exchange to do, and in the immediate postwar years, American industry owned the world.

But by the early 1980s, American industry was no longer a money machine: many corporations were too large and too inefficient; many managers had lost their edge. Under such circumstances, it was hardly to be wondered that there existed numerous investors, themselves normally docile, who were willing to listen to a new arrival with (he said) a fresh idea, and even

Shares of stock in Gulf or any other company represent fragments of ownership, a fact often forgotten. Buy enough of them, and you can demand the key to the front door

Mesa continued to develop the divested properties, a carefully selected mix of short-lived and long-lived wells, recovering, by arrangement, 90 percent of its costs immediately and recouping the rest, together with its profit, out of its stake in the trust. The holders of the remaining 90 percent of the trust units received what was left. It was, as the late Frederick Lewis Allen might have said, a masterpiece of legal humor. Pickens had divested himself of a full half of his company and, at the same time, he had kept it.

Gulf would reincorporate in Delaware—and Pickens would be kept off the company's board. The problem was easily solved, or so Gulf thought

to join him in his quest for corporate reform, allying their shares with his in a joint crusade. Others, more cautious, simply sold him their stock when he was able to arrange a premium, either by forcing the price upward on the exchange or by making a "tender offer" for a fixed number of shares at a predetermined price. In either case, the result was the same: the raider got the shares.

While there is no way in the world that the management of a publicly traded company can stop an investor with bottomless pockets, there are ways to make his quest difficult, expensive, or too profitable to continue. Management can pay greenmail, of course. Of the other remedies available, "shark repellent"—staggered boards of directors, supermajorities, Delaware reincorporation—is perhaps the simplest. More difficult, and far more dangerous to the company involved, is the "poison pill" defense. In this ploy, a raided corporation pollutes the waters, perhaps fatally, by assuming a crippling burden of debt or by issuing more (and thus weaker) stock. Lastly, management might attempt the most difficult method of salvation, a "leveraged buy-out." Leverage is debt; in a leveraged buy-out, management puts up a company's assets as collateral on a loan, uses the money to buy back the company's stock, and then pays back the loan by selling all or part of the new, now privately held company. Whether or not anything useful is accomplished by this is a matter of some debate, but managers get to keep their jobs and, perhaps, make a little money.

All of these tactics were available to Gulf when its executives met with Larry Rand at the Union League Club. It only remained to be seen which of them the company would use, and how its defense would be organized.

Pickens, Gulf knew, had been a busy man. In the wake of the Cities ploy, he allowed himself to be bought out of Supron Energy, a Dallas company that had first attracted his attention in 1978, for a net profit of $22.2 million. At General American Oil, where he had maintained a position since 1976, he bid $40 a share for 51 percent of the company, forced it to seek a white knight in the form of his old employer, Phillips, and emerged with $25.3 million. He bought a 3 percent stake in California's Superior Oil, where the founder's children, Howard B. Keck and Willametta Keck Day, were engaged in a struggle that was ostensibly over Pickens's favorite issue, shareholder rights. (Mrs. Day was convinced that her brother had bugged her home; Pickens visited her and, totally unabashed, took the opportunity to explain himself by addressing the walls and the empty air. Later he learned that the quarrel apparently originated long before, when Howard strangled Willametta's pet ostrich by stretching its neck through a picket fence and placing an orange in its mouth.) Pickens emerged from this experience with a net profit of $13.7 million. And he pulled Mesa out of Australia, withdrawing his operations to the safety and benign tax laws of the United States, with a pretax profit of $26.5 million.

It appeared to occur to no one at Gulf that Boone Pickens had raised a great deal of money in a very short time. Nor did it occur to anyone at Gulf that Pickens might make a serious run at the company. Gulf was the fifth largest oil company in the country; Mesa ranked ninety-second. Worldwide, Gulf employed more than 40,000 people; Mesa employed 700. Gulf's revenues in 1982 were $30.630 billion; Mesa's were $407 million. In 1982, Gulf lifted 182 million barrels of oil; Mesa produced 4.4 million. Gulf's worldwide properties were assessed at $20.4 billion; Mesa's oil and gas holdings, virtually the whole of the company, were worth $1.009 billion. Gulf owned or supplied thousands of service stations that sold 716,000 barrels of its refined products every day; Mesa's entire production of oil and natural gas condensate was 10,403 barrels a day. Gulf had once virtually owned the country of Kuwait; Mesa wasn't even the largest company in Amarillo.

Although the relevant executives believed that a serious attack on a company as immense as Gulf was patently ridiculous, they did detect one small, annoying window of vulnerability. Gulf was a Pennsylvania corporation, and Pennsylvania law required "cumulative" voting for boards of directors: in effect, the owner of each share of Gulf stock cast thirteen votes. These votes could be distributed, one for each of the thirteen seats on the board, or they could be cast in a block for a single seat; a shareholder with 7.2 percent of the company's stock had the power to place his representative (or himself) on the company's inner council. This, Gulf figured, was obviously Pickens's plan. He would elect himself to the board, fog up the atmosphere with a lot of bumf about his royalty trust, and generally make a nuisance of himself until he was bought out. Very well, the problem was easily solved: Gulf would reincorporate in Delaware, where there was no cumulative voting, and it would do so as soon as possible, well before the annual meeting next May.

Pickens would be taken by surprise. If he chose to fight, he would do so on a ground and at a time of Gulf's own choosing. If the upstart Pickens persisted, he would learn a lesson he would never forget. And Larry Rand would obtain a valuable new client.

HOUSTON. The law offices of Baker & Botts.
October 29, 1983.

Boone Pickens was a punctual man. The meeting at the Houston offices of his attorneys, Baker & Botts, began at precisely 9 A.M., the scheduled hour. Pickens, trim and carefully dressed, surveyed the room. "Thank you all for coming," he said.

It was the first all-hands gathering of the Gulf Investors Group, an alliance Pickens had forged three weeks before, on October 5, in a secret meeting at Houston's Meridien Hotel. During the Cities deal, the target had broken up his partnership. But the concept was sound, and Pickens was ready to try again. He chose his associates with care. Aboard were Mike Boswell of the Sunshine Mining Company, a staunch friend during the Cities deal, and the Belzberg brothers, Sam, Bill, and Hyman (sometimes called "the mysterious Belzbergs" by the financial press because it knew little about them and found it difficult to believe the little it did know—the family fortune was based on a used-furniture store in Calgary, Alberta). Rounding out the group were Cyril Wagner Jr. and Jack E. Brown of Wagner & Brown, an oil and gas partnership, and John M. Harbert III of Harbert International, a closely held Alabama construction and real estate firm. They had learned the identity of the target on October 5, although some of them had guessed it from the background material Pickens had provided before that meeting. None of them were intimidated. They were all still in.

From August 11, when he had first instructed Ace Greenberg to begin purchasing Gulf stock, to the first meeting of the investors group on October 5, Pickens had been horribly vulnerable to the one sure and effective counterattack Gulf could have made, a counterattack that would have halted him in his tracks and destroyed his life's work. Again, the Cities deal showed the way: Cities, in yet another all-time first, had tendered for the stock of Mesa, its attacker, before Mesa could tender for it. Gulf was far wealthier than Cities Service, and could easily have offered a handsome price for Mesa; the institutional holders of Mesa's stock, bound by their fiduciary responsibilities, would have had no choice but to offer up their shares.

But Gulf did nothing. The fact was, Gulf was large and rich—and weak. Founded in 1901 by Andrew W. and Richard B. Mellon as the J. M. Guffey Petroleum Company, it was the only American oil major that did not join Aramco, the consortium that long dominated the rich production of Saudi Arabia. Gulf concentrated instead on its abundant finds in Kuwait and Venezuela, developing an extensive downstream operation in Europe solely to process and distribute the Kuwaiti feedstock. But the Kuwaiti and Venezuelan fields were nationalized in 1975, leaving Gulf with its European refineries, which made no money, and the European marketing apparatus, which made very little. The company's worldwide production fell by 80 percent and its return on equity shrank to 9.5 percent, well below the industry average. In 1976, chairman Bob R. Dorsey and two vice presidents resigned in a bribery scandal—among the pay-outs was the standard $100,000 unreported contribution to the Nixon re-election campaign. Expecting a boom in nuclear power, Gulf went heavily into uranium production, investing $419 million in a mine at Mount Taylor, New Mexico. The nuclear power industry did not boom. In 1964, believing it had hit a vast pocket of natural gas in the Gulf of Mexico, Gulf had negotiated a contract with the Texas Eastern Transmission Corporation that required Gulf to do one of two things, whichever came first: deliver gas for twenty-six years or deliver 4.4 trillion cubic feet. Either way, Gulf had to provide the gas at the fire-sale price of between nineteen and twenty-one cents per thousand cubic feet. But Gulf hadn't hit gas—it had hit water. With its great discovery a bust, Gulf found itself buying gas dear and selling it cheap in order to make up the 500-million-cubic-foot daily minimum stipulated in the contract; between 1972 and 1976 even this proved impossible. In 1982, Gulf paid Texas Eastern a refund of $45 million and another $48 million in interest, and it still had a trillion cubic feet to go.

There was more. Like many of the majors, Gulf had too many people doing too little work. Its stateside refineries began to lose money as conservation measures began to take hold, creating a surplus capacity; its marketing apparatus was overextended; its chemical and plastics divisions ate money. Moreover, it never seemed to find as much oil as it pumped. Just as Pickens said, Gulf was liquidating.

A royalty trust, if it worked the way Pickens believed, would rectify this deplorable situation. It would also (and not incidentally) make Pickens and his partners a great deal of money. But a trust was not the only way the trick could be turned. If Gulf successfully resisted the trust idea, Pickens and his partners

Pickens believed he had an unwitting ally in James Lee, Gulf's chairman. Their battle would be joined on the stock exchange, of which Lee had little understanding

would obviously be left with a great deal of stock, but they would not be all dressed up with nowhere to go. There would be no question of dumping the stock—the price would instantly head south, which was hardly the point of the exercise. The point of the exercise was to make money. It would therefore be necessary to find a way to put the stock in play, to render its price unstable. There are several tested ways of driving the price of a stock upward; all it takes is money.

If it became necessary to go the stock market route, Pickens had reason to believe that he possessed a powerful ally, almost a fifth column, in the form of James Lee's demonstrated lack of comprehension of the mysteries of the marketplace. Like many corporate bureaucrats—and Lee was the very model of the modern corporate bureaucrat—Gulf's chairman and the men around him had little practical understanding of the stock exchange, where the battle would be joined; no one who knew the faintest thing about the marketplace would have bailed out of Cities the way Lee and his people had done.

There was one other possible source of assistance inside Gulf. Harold Hammer, the company's executive vice president and chief administrative officer, would very likely direct Gulf's defense. Hammer believed himself to be something of a whiz at corporate strategy. But there were those among Gulf's closest allies who believed Harold Hammer was an unmitigated disaster.

Three weeks before the meeting at Baker & Botts, the Gulf Investors Group had bought 2,758,183 of the shares previously acquired by Ace Greenberg. In addition, the group agreed to raise $550 million for the next phase of the operation. Mesa pledged $365 million. The Belzbergs kicked in $50 million, and so did Harbert International and Wagner & Brown; Sunshine Mining, with $35 million, was the junior partner. All future purchases of Gulf stock would be coordinated through Mesa Asset, a wholly owned Mesa subsidiary created for the purpose. Ace Greenberg would buy 6.3 million more shares, giving the group 8.75 percent of Gulf. This time, there would be no slip-ups. If Gulf made a run at Mesa, the voting rights of the Gulf stock held by Mesa Asset would immediately and automatically transfer to Harbert International. The vast majority of the stock in Harbert International was held personally by John M. Harbert III. Gulf could buy every single share in Mesa Petroleum, throw Boone Pickens's desk into the street and chop it into firewood, raze One Mesa Square, sow the site with salt and divert a river over it, and the raid would still go on. Gulf's one chance of avoiding a fight was gone.

There had been few developments since the investors group first met on October 5. Lehman Brothers was retained as the group's investment banker. On October 17, as required by law, the investment group filed a Schedule 13D with the Securities and Exchange Commission, making itself known, identifying its members and the assets they controlled, and mentioning the possibility of a royalty trust. Ace Greenberg was buying openly now. On October 21, he purchased 2.5 million shares at $47.25 a share, one of the largest single cash transactions in the history of the New York Stock Exchange. On October 24, the group amended its 13D and revealed that its holdings had reached 17,932,700 shares, or 10.8 percent of Gulf.

Meanwhile, Gulf had finally begun to move. On October 11, the company announced that it proposed to reincorporate in Delaware; a stockholder meeting would be held in early December to ratify the decision. The purpose of the step, one Gulf executive told the press, was to keep a "Wall Street wolf" from "shooting his way onto the board." A company seeking to reincorporate must file proxy materials with the Securities and Exchange Commission before holding any special stockholder meeting. Proxies are slips of paper that represent voting rights on shares of stock. On October 26, Gulf filed its proxy materials with the SEC, and Pickens and his associates studied them closely. To their amazement and delight, they discovered that Gulf proposed to do absolutely nothing but reincorporate itself. There was to be no stronger shark repellent—no staggering of board terms, no supermajority.

Gulf thought Pickens wanted nothing but a seat on its board.

No sooner had Pickens thanked those on hand at Baker & Botts for coming than he turned to Donald Carter, one of the many specialists engaged for the struggle.

"And now," Pickens said, "Don Carter will tell us how we're going to win this proxy fight."

Carter was a man after Pickens's heart: young at thirty-six, aggressive, humorous. In the arcane world of mergers and acquisitions, he was an information agent, a specialist in the solicitation of proxies. It was Carter's job to obtain these slips of paper (and the votes they represented) for his employers, a task that required nerve, energy, and skill, qualities Carter possessed in abundance. He was especially adept at locating the real owner of stocks held in "street name"—that is, in the name of the brokerage where the stockholder maintained his account. But how he did this he would not say.

Carter didn't think the investors group could win the proxy fight—nor was he prepared to formulate a strategy. Nevertheless Carter, as

The proxy fight waged in November was the largest and most expensive in history. Pickens admitted to spending $7.5 million; Gulf probably spent more

usual, was at no loss for words. He realized that by calling a special stockholder meeting in early December, Gulf had provided Pickens and his partners with a priceless gift: time. Gulf stockholders, Carter explained to the group in the law office, had not been scheduled to meet until May—seven months off. Now, Pickens would have a chance to introduce his royalty trust—an idea not easy for ordinary investors to grasp—in December; he would have the balance of the winter and all spring to explain the plan.

Pickens told Carter to go back to New York and start work. It was time to get cracking.

PITTSBURGH. The David L. Lawrence convention center. December 2, 1983.

It was snowing and bitterly cold when 3,000 Gulf stockholders filed into the David L. Lawrence convention center for the special reincorporation meeting. Don Carter had flown into town at one-thirty in the morning aboard one of Pickens's three jets. A local television crew was waiting to record his arrival. In Pittsburgh, the capital of the Rust Belt, the battle for Gulf was the biggest story in town.

The proxy fight waged in November had been the largest and most expensive in American corporate history. Pickens admitted to having spent $7.5 million, and Gulf's expenses may have run as high as $9 million. Mesa's gray-haired, thirty-five-year-old vice president for finance, David Batcheldor, had pounded the pavements. "We'd do the rounds of the big institutional investors and talk about how we opposed reincorporation," he later explained. "That takes about thirty seconds. Then we'd spend the rest of the time explaining the royalty trust."

Unexpected support for the concept of a royalty trust came from the influential New York brokerage house of Donaldson, Lufkin & Jenrette. Word circulated in London and New York that Pickens was on the verge of acquiring an Arab partner, possibly a Saudi; Pickens had no such prospective partner, but he artfully refused to comment. Lehman Brothers drew up a "black book" for the investors group, projecting the probable effects if Gulf spun off 10 percent, 25 percent, 50 percent, 75 percent of its reserves into a trust. Gulf countered with a "white book" challenging Lehman's figures.

Pickens, giving every appearance of enjoying himself hugely, held a briefing for over 200 financial analysts in the Empire Room at the Waldorf-Astoria in early November, where he told the world that the investment group would never allow Gulf to buy it out. There would be no greenmail; he and his associates were advocates of shareholder rights. On November 22, Ace Greenberg again began to buy stock. (By law, he had been forced to stop buying for three weeks during a "standstill" period, while the Federal Trade Commission examined the antitrust implications.) He especially bought stock that had been held before October 21, stock with valid proxies attached; no share traded after that date could be voted at the special meeting.

Gulf, meanwhile, had assembled its team. Georgeson & Company and D. F. King—firms that had more or less owned the business before Don Carter appeared on the scene—were engaged as information agents for $175,000 a month and expenses; Sullivan & Cromwell and Reed, Smith, Shaw & McClay were assigned the legal work. Salomon Brothers was formally appointed investment banker and assigned a fee of $200,000 a month. (Lehman Brothers, the investors group's investment bankers, was to receive from the investors group a minimum of $1 million and possibly as much as $7.5 million, but only if Mesa was taken over.) Gershon Kekst and Larry Rand were assigned public relations.

Many of Gulf's tactics had seemed strange to those on the sidelines. The company's line of credit was raised from $1 billion to $5 billion. "Let's just say for the moment that we're strapping on our six-shooters," one of Gulf's advisers had told the press. But the fresh money was not used. And as if the white book were not enough, James Lee and his council of war met in New York with a number of security analysts and explained why a royalty trust was a terrible idea. Pumping bullet after bullet into their own feet, Gulf executives padded around in David Batcheldor's footsteps, talking about liquidation and spinoffs and cash flow. In newspaper ads and a veritable blizzard of letters to its shareholders, Gulf dissected the trust concept, suggested that Pickens would never be able to sustain his investment and was therefore nothing but a mischievous greenmailer, and in general pushed its corporate invective to the limits permitted under prevailing regulations. Lobby-

ists were dispatched to Washington to urge legislation that would cripple royalty trusts, spreading the word to a new quarter. The upshot, of course, was that everybody who was supposed to be talking about reincorporation was talking about royalty trusts—just as Pickens and Carter had hoped.

Meanwhile, Harold Hammer, Gulf's field commander for the proxy fight, seemed to have taken leave of his senses. Hammer told the press that he was going to "wear the black hat. We've got to kick him where it really smarts." A Gulf spokesman tried to dismiss Hammer's remark as "an isolated, single incident," but it was no such thing. "Who is Pickens anyway?" Hammer remarked to a *Fortune* reporter. "Everything he says is horse..... and hot air. You can take a high road or a low road, and I'm taking the low." It did not seem to occur to Hammer that carrying on like this was not exactly a good idea, in view of the fact that he was an officer of a major oil company, hardly one of the country's more beloved institutions. Nor did it seem to occur to anyone at Gulf that hiring private detectives to dig for dirt in Pickens's background (and letting Pickens find out about it) was hardly an inspired stroke of tactical genius.

Gulf had more than 30 million shares of repurchased stock in its coffers, but there was no poison pill—the shares were not used to dilute the outstanding issue, which would have weakened Pickens's position and eaten into his cash reserves as he made up the loss. And there was no talk of a leveraged buy-out.

"I can't understand what Gulf is doing," an investment banker told the *Wall Street Journal*. "I know the people they've hired in the street and how they think. Gulf can't possibly be listening to them."

If the stockholders attending the special Pittsburgh meeting expected to hear James Lee deliver a spirited and detailed defense of his stewardship, they were sadly disappointed. And yet if Lee had wished to, he could have told a stirring tale. It so happened that the Gulf chairman agreed with Pickens: Gulf had indeed been liquidating itself. But Lee had been very effectively doing something about it.

Like Pickens, he was a Presbyterian elder, but unlike Pickens, he looked the part: courtly and balding at sixty-two, he more closely resembled a Sunday-school superintendent than the chief executive officer of a corporation whose budget was larger than that of many countries. He joined Gulf as a chemical engineer in 1943 and remained there for the next forty-one years, slowly ascending the corporate ladder: he became president in 1973, escaped the purge of 1976, assumed the chairmanship (and became CEO) in 1981. As too often happens in corporate America, it was only then that he was able to strut his stuff.

Some officers and employees he encouraged to retire; others he fired outright. (In 1981, Gulf employed 58,000 people. By 1983, the number was 42,700 and falling.) He began to repurchase Gulf stock on the open market; return on equity rose to 9.9 percent.

He pulled Gulf out of continental Europe, selling the company's installations to Royal Dutch/Shell and the Kuwait Petroleum Company for $258 million. In the United States, he assembled a trillion cubic feet of natural gas to satisfy the Texas Eastern contract; sold the refinery in Santa Fe Springs, California; retooled the others to take heavier and cheaper feedstock; and closed or sold 1,100 service stations in upstate New York, Vermont, Michigan, and northwestern Ohio. He sold unprofitable chemical plants and concentrated on plastics, where sales were up. Most importantly, he began to find some oil.

Domestic reserves did fall from 865 million barrels in 1980 to 723 million barrels in 1983, but the company's total world reserves were virtually stable, dropping slightly from 1.482 billion barrels to 1.472 billion. There were important offshore strikes at Ras al Khaimah, in the United Arab Emirates, and in Zaire, where Gulf owned half the concession. Production doubled in Angola, two new fields were discovered in Nigeria, and Gulf struck oil in the Celtic Sea off Ireland, where no one had ever found oil before. Lee, unlike his predecessors, also located new oil in the United States. More than half of any oil pool remains in the ground in a played-out field; under Lee, Gulf experimented with new technologies to bring that oil to the surface. Thanks to the revised leasing policies of the federal government, it became possible to explore entire subsurface geological structures rather than random portions of them; Lee proposed to conduct a vigorous search. He also set great store in the possibility of finding oil on the frontier. No one had ever looked for oil north of the Barrow Arch in Alaska, but Lee planned to do just that. There were promising geological structures off the California coast near Santa Barbara and off Point Pedernales, where a well drilled in 1983 tested at 4,300 barrels a day. Other likely prospects existed off the coast of Louisiana and in the Overthrust Belt of the Rocky Mountains, and there was still plenty of oil in the mature fields of Texas and New Mexico; in 1982, the first full year of Lee's tenure, Gulf drilled 1,095 development wells in the older fields.

In 1981, Gulf found 39 million barrels of domestic oil. In 1982, it found 53 million barrels,

Gulf was doing just as Pickens had hoped. Instead of talking to stockholders about reincorporation, Gulf was talking about royalty trusts

Gulf won the December vote in Pittsburgh, and its spokesmen said Pickens had been crushed, humiliated, and beaten forever. James Lee was not so sure

with 9,000 barrels a day coming from enhanced recovery techniques. Lee confidently predicted that by 1984, Gulf would replace its American reserves for the first time in years. The company would no longer be liquidating itself.

Here was something James Lee could seize upon, use to Gulf's advantage, throw up in Pickens's face as he sat among the stockholders. But, with force and unaccustomed eloquence, James Lee talked about *royalty trusts*.

HOUSTON. The law offices of Baker & Botts. January 5, 1984.

Pickens, as usual, convened the meeting punctually. "And now," he said without preamble, "Don Carter will give us his analysis of the proxy vote and tell us what we have to do to win next time."

The week before, on December 30, the Corporation Trust Company, appointed to review and validate the votes and proxies cast at the December 2 meeting, had announced its preliminary findings. Eighty-five percent of the stock had been voted. Gulf carried the day with 52.7 percent, seven tenths of a point more than Carter had predicted in October, which was very good predicting indeed. The company immediately declared a mighty victory, making a rapid computation. Gulf spokesmen pointed out that if Pickens's own holdings were deducted from the total, he had been beaten by 3 to 1, a ratio that was decisive, crushing, humiliating, and final.

James Lee was not so sure. He knew Pickens—not well, but well enough to realize that he was tenacious. There would be, Lee suspected, a second proxy fight, at the May meeting, and it would be wise to be prepared. The steering committee that had handled the December 2 confrontation was expanded. There would be a media campaign (Lee would receive special television training). There would also be a fresh round of fight letters to stockholders, a new lobbying effort in Washington, and a series of speeches by senior management. May was four months off; Gulf thought it had all the time in the world.

This time, when Pickens called on him, Carter was ready. The investors group had not been idle. Ace Greenberg had purchased 457,000 more shares of Gulf, after which he withdrew from the fray. Mesa and its partners now owned 13.2 percent of the company. Carter distributed mimeographed sheets of figures and went to the blackboard for a little chalk talk. The situation was fluid, he explained. The stock was changing hands again as the arbs and other speculators took their profit on the modest run-up that Pickens had caused. Carter suggested that the group pick up another 12 percent. Sam Belzberg interrupted him.

"Why go for just 12 percent?" Belzberg asked. "Why not go for the whole thing?"

PITTSBURGH. The Gulf Building. February 1, 1984.

James Lee put down the phone, stunned. That odious pipsqueak in Amarillo had just blind-sided Gulf real good.

It would seem that Pickens was a man of many unexpected talents. In addition to possessing oratorical and financial skills, he was also a consummate actor; for the past five weeks or so, he had treated Lee to a superb imitation of a man baffled by events. Neither by word nor by deed did he even hint that he was doing other than grasping at any straw that might enable him to salvage his investment. Late in December, on the very day that Corporation Trust made its preliminary report, the investors group formally presented Gulf with a sixty-two-page royalty trust proposal drawn up at Lehman Brothers, it claimed to show, with elaborate tables and exhaustive documentation, what would happen if Gulf spun off 50 percent of its proven reserves and 5 percent of its unexplored acreage. Pickens must be out of his mind. Gulf curtly rejected the proposal with a page-and-a-half letter.

A concerned stockholder, Pickens called Lee and complained about Gulf's expenditures in the Beaufort Sea, where the Cross Island well was an apparent bust and the Mukluk well, in which the company had a small stake, had just

come in as a billion-dollar dry hole. Pickens also suggested that Lee sell Gulf Canada. He met with Lee and Philip E. Wyche, Gulf's vice president for exploration, to renew his complaints and to beat again upon that old dead horse, his royalty trust. Well, the man had to be accommodated. He and his group were the company's largest stockholders, and fair was fair.

But today Lee began to learn what Pickens had really been up to. February 1 would not be remembered as one of James Lee's better days. First of all, a memo began to circulate around the company. While Pickens was querulously airing his tired complaints, it seemed that he had formed something called the Gray Investors Group.

It would be some days before Gulf was able to lay hands on the actual Gray proposal, but its purpose was quickly deduced: Pickens intended to destroy Gulf in a new and entirely unanticipated way. And he was almost ready to strike.

The place to find the money, Sam Belzberg had told his fellow investors at the January 5 meeting in Houston, was the investment banking house of Drexel Burnham Lambert. The next day, Pickens found himself explaining the situation in Drexel's Beverly Hills office, where the New York-based firm maintained its high-yield-bond department. Drexel did not hesitate. Its emissaries went to Amarillo on January 12 to receive the necessary background information, and on January 21 Drexel was ready with a draft proposal.

To someone unfamiliar with the intricacies of high finance in modern America, the Drexel proposal remains all but incomprehensible. But it had one great advantage: it would work. To tender for Gulf at $55 a share, the price Drexel concluded would be the most feasible, Drexel estimated that Pickens and his partners would need $3.657 billion. The investment group would raise $482 million, Lehman would drum up a billion dollars from the banks, and Drexel would produce the balance by selling $450 million worth of senior notes—known in the trade as "junk bonds"—and $1.725 million worth of senior preferred stock in Newco, a company Drexel would weave from the filaments of dream. Another masterpiece of legal humor, Newco would toil not and neither would it spin, nor would it require a proper corporate name—Newco was simply a contraction of "new company." It would produce nothing, erect no edifices, and leave only one trace of its passage: it would murder another company, referred to in the Drexel proposal as "Gray" (read Gulf). If the figures were correct, the banks cooperative, and the Newco stocks and bonds marketable, Gulf was as good as dead and Drexel was worth every penny of its fee.*

Except that Drexel was working for free, it had signed no contract and received no retainer. (It had been promised $500,000. A promise

"Newco would first tender for 61.3 million shares of Gray's common stock at $55 a share; when combined with the Gulf investors group's holdings, this would give Newco a clear majority of Gray. Then the complicated part would begin.

Newco would spin off an equally fictitious (but equally legal) subsidiary, which would merge with Gray (Gulf). Gray's surviving stockholders would be rewarded for their tenacity with junior subordinated debentures—when the pie is sliced, the holder of a junior subordinated debt instrument is served last—and get more of Newco's preferred stock. Newco's senior noteholders would be repaid either thirty days after the merger or on December 15, 1984, whichever came first. The holders of senior preferred stock would receive a cumulative quarterly dividend of 14 percent, a liquidation preference of $1.725 billion plus interest if (by some stroke of fate) it became necessary to lead Gray to the knacker's yard, an option to convert their stock into senior subordinated debentures (which Drexel estimated could be sold on the open market for $1.967 billion), and a firm commitment that, whatever happened, they would see their money and their profit within five years. They would also receive all of Newco's class-B common stock, which—since Newco existed only to absorb Gray—would give them a further 25 percent interest in the target.

As for the Gray Investors Group, it would own $762 million worth of Newco series A junior preferred, $735 million worth of series B junior preferred, and all of the class-A voting common, which represented the remaining 75 percent equity interest in Gray (Gulf). Series A junior preferred would pay no dividend. Series B would pay 12.25 percent and would be redeemed at the time of the merger, when other things would begin to occur.

At merger, Newco would borrow $3.351 billion—a simple matter, considering the $5 billion in credit that Gray had amassed in its war chest—and with it repay the banks and the senior noteholders while retiring $1.166 billion of Gray's outstanding debt. At the same time, the investment group's $735 million in class-B preferred would be redeemed and $285 million in interest would be paid. Gray's surviving shareholders, now entrapped in Newco, might be offered Gray's 60 percent interest in Gray Canada, but this would be decided later. Meanwhile, another mysterious entity, the Blue (as in Mesa) Petroleum Company, would move in to manage Gray's assets.

And what then? For starters, Newco and Blue would pay the remaining bills by tearing Gray apart and selling off the pieces, up to and possibly including Gray's domestic wells and undeveloped acreage. If that were to happen, the holders of Newco's senior debentures would receive between $520 million and $1.266 billion in additional cash, and although the Drexel proposal did not mention it, the investment group's additional share would be between $1.56 billion and $3.732 billion. There was one wrinkle. Because Newco's intended role as corporate assassin would become immediately apparent, and because Newco's structure made it impossible to attack and equally impossible to resist, it was likely that Gray would seek a white knight. And Pickens knew perfectly well that Gray was worth considerably more than the $55 a share that Newco would tender for. In short, Drexel was not merely proposing to make everybody a lot of money, it was proposing to make everybody an enormous amount of money.

It seemed Pickens intended to destroy Gulf in a new and entirely unanticipated way

Lee phoned the chairman of the Standard Oil Company of California. He hastened to mention he wasn't looking for a white knight

is not the same thing as a contract.) Drexel later claimed that its plan of raising more than $2 billion in three weeks seemed like an unlikely bit of business and that Pickens would have been justified in suspecting that it was impossible—and not worth paying for up front. Drexel (according to Drexel) therefore preferred to get to work and collect its fees only after it had placed the money in the hands of the skeptical but delighted Pickens. (One can only hope that this practice will spread.)

There was another explanation, however, one that makes more business sense. The moment Mesa and Drexel signed an agreement, the investors group would be obliged to amend its 13D at the SEC, publicly announcing the compact and its purpose. But as long as Drexel signed nothing and received no fee, the SEC—and Gulf—would never know anything was afoot unless someone talked.

Pickens always liked to move fast; the reason he left Phillips, he always said, was that the company proposed to take two years to drill a well he believed could be drilled the next day. On January 22, only twenty-four hours after the Drexel proposal came in, Lehman Brothers contacted Marine Midland, searching for the billion dollars in bank money; on January 25, Marine Midland agreed to study the situation in return for a $75,000 fee. February 23 had been selected as the day to begin the tender offer. Pickens and his aides were almost done making the rounds by the time James Lee obtained the Gray proposal; the circle of potential investors had grown to over 100. Citibank was in. The Harvard University Endowment Fund was in. So was the Teachers Insurance and Annuity Association. On Wall Street, someone seemed to know something, as Drexel's pieces began to fall into place, the price of Gulf common rose by 20 percent. The arbs, some of them, were beginning to take their positions.

And now James Lee knew something, too—not all of it, but enough. He was about to be attacked by a phantom from a direction he had never suspected. But word of Gray and Newco was only one of two pieces of terrible news he received on this first day of February. The other came in the form of a phone call from Robert O. Anderson, the chairman of the Atlantic Richfield Company (Arco).

Anderson had been heard from before. On January 22, Lee and Harold Hammer flew to Denver and met with both him and Arco's president and chief executive officer, William F. Kieschnick. Anderson proposed a merger but mentioned no numbers; Gulf, it was understood, would not be the surviving corporation. Lee said that he wasn't interested, but Anderson was not easily put off. On January 30 and again on January 31, he placed phone calls that were both very interesting and very fateful. The calls were placed to the Mesa Petroleum Company of Amarillo, Texas.

Arco, Anderson told Pickens when he reached him on the second try, wanted to make a 100 percent acquisition of Gulf, but it would not act in concert with Mesa or the investment group. Would Pickens meet with him and discuss the matter? Pickens hedged. A meeting would not be useful, he told Anderson, unless Anderson could come in with a price higher than the 60s. Anderson called back an hour later. "We can get it to 70," he said. Pickens immediately flew to Denver.

It would have been relatively easy for Arco to acquire Gulf. In January 1984, Arco was the eighth largest oil company; more to the point, it was an excellent credit risk, and the battered banks, reeling from bad Third World loans and even worse loans in the oil patch, were in need of just such a client. At $70 a share, Gulf would cost around $12 billion, and the commercial loan needed to acquire it would be the largest in history. But with Arco's annual revenues of $27 billion and its cash flow of $10.1 billion, it was clear that Anderson could afford it. The only problem, he told Pickens, was that he wanted to make a friendly acquisition. And Lee was in no mood to be acquired.

Time was no longer James Lee's friend. In fact, James Lee had no time left at all. On February 1, Anderson repeated his offer and named a money figure. He had, Anderson added, already discussed the matter with Boone Pickens. This was terrible news. Anderson was offering $70 a share, *and Pickens knew about it.* There was no way of knowing what he would do with the information, but he was certain to do something. At the time Pickens began his run at the company, Gulf was trading at 38¼. It was now 57½, and the board of directors had not been born that could withstand the wrath of the assembled shareholders if it turned down a $70 premium like the one Anderson was offering. If word got out, Gulf was finished.

Charles Boyce, the company's secretary, was told to round up as many directors as he could find; Boyce located three of the thirteen. Lee told the assembled directors that he proposed to contact the heads of several companies. He called five. (Harold Hammer called a sixth.) One of them was George M. Keller, chairman of the Standard Oil Company of California. The two of them should keep in touch, Lee said. Boone Pickens was about to tender for Gulf. Lee hastened to add that he wasn't looking for a white knight. But Keller understood what he was saying.

PITTSBURGH. The Gulf Building. March 5, 1984.

These things always took time. Gulf's board of directors had been meeting for hours, and still no word.

The board had already met twice during the preceding month. It held its first emergency meeting on February 10. Gulf had obtained a copy of the Gray proposal; Jay Higgins of Salomon Brothers critiqued the document. The board authorized three courses of action. First, Gulf would sue Mesa, the Belzbergs' First City Properties, Sunshine Mining, Drexel, and Bear, Stearns for market manipulation. Second, the company's line of credit would be expanded by an additional billion, to $6 billion, although this was no longer enough for Gulf to pull off a leveraged buy-out—Pickens had seen to that. Third, Lee would get more details from Anderson. At this meeting, Gulf's executives also prepared their golden parachutes. Gulf would later claim that no such thing had happened, and it was true that the board did not distribute employment contracts. Instead, it amended the stock option plan to enable management to get its money out in cash, either immediately or six months later, if the company was taken over. In addition, the board poured over $14 million into the Incentive Compensation Plan, $7,158,900 of it payable immediately, and it secured management's pensions.*

Lee never contacted Anderson; in fact, he canceled their scheduled meeting. The billion dollars in credit was obtained, but, typically, it was never used. The suit against Mesa went forward, but it was too little and too late.

Four days later, on St. Valentine's Day, Gulf was blown out of the water. Citing unnamed "Wall Street sources," Robert J. Cole of the *New York Times* broke the story of Arco's $70 bid. (Gulf was then selling at 57½.) Gulf immediately denied that any such offer had been made, but the denial had no more effect than King Canute's marching orders to the sea; as far as the arbs were concerned, a trading ceiling had been established, and those who did not already have positions in the stock rushed to do so. Gulf Oil was as good as sold. It only remained to discover the identity of the buyer.

When the board convened again on February 14, the company's investment bankers warned that "market professionals" were taking positions in Gulf stock—in other words, the sidelines were emptying. There was only one thing Lee could try to do with a reasonable chance of success. He could try to prevent Boone Pickens from sitting in his chair.

Later, the accusations would fly thick and fast. Pickens and others would suggest that Harold Hammer, everybody's favorite villain, had leaked the story. (It was not Harold Hammer.) The Gulf people would point at Pickens, whose motives had the virtue of being clear, but it was not Pickens. Still others would suggest Don Carter. In truth, the source of the story could have been almost anyone. It no longer mattered. All the arbs were in.

On February 15, Pickens had abandoned Newco, a concept he had never been entirely comfortable with, or so he said. New circumstances required new tactics, and Pickens had never been a man to dwell in the past.

Gulf would later claim that its lawsuit against the investors group had destroyed Newco. But that was not the case. Actually, the Gray initiative was in splendid shape—in rather too splendid shape, as far as Pickens was concerned. To sweeten the deal, Pickens had promised his new partners 15 percent of the profits if he was outbid for Gulf, which was unlikely to happen as long as he was alone in the field. But if he got into a head-to-head bidding war with Anderson or the white knight Gulf would surely recruit, he would find himself giving away money that he would rather keep. For example, if he couldn't match Arco's $70 a share—and he couldn't—the Gulf investors group would make $553 million, but it would have to give $83 million to the Newco investors. There had to be another way.

While Pickens was thinking, Lee called John Harbert and offered to buy out the investors group for $70 a share. Harbert conveyed the offer to Pickens, and Pickens turned it down. Seventy dollars a share was no longer enough.

On the day of the emergency meeting, Harold Hammer executed a stock appreciation right (SAR) on 95,000 shares in his stock option plan, selling at 57 and realizing a capital gain of $2,432,950. Pickens would later make much of this transaction, together with a similar transaction the previous November, in which Gulf's president and chief operating officer, Edward B. Walker III, had executed an SAR on 160,000 shares at 47, realizing a capital gain of $2,557,000. With some plausibility, Pickens would claim that two of Gulf's three top executives had not the faintest notion of the true value of their company's stock and that their subsequent denunciations of his activities were the merest eyewash. When the final tally was in, it was clear that Hammer, by selling early, had walked away from $2,185,000, pretax, while Walker, before taxes, had left close to $5 million on the table. Although some controversy surrounded the transactions, they were never reported to the SEC.

Pickens believed he could get Gulf above that, and he believed he knew how.

He decided to tender for 13,500,000 shares of Gulf at $65 a share. With the stock already in hand, this would give the investment group 21.3 percent of the company, a significant figure. In view of the shareholder support Pickens had received at the reincorporation meeting, 20 percent of Gulf would be enough for the investors group to take over the company. If push came to shove, Pickens could spin off a royalty trust, perhaps sell the downstream operations, and sit back to await results, but probably none of this would be necessary. Such a move had been possible all along, but it was obviously the worst-case method of going about the task. (It had not been obvious at Gulf. Only now would memos make the rounds pointing out that Pickens had been entirely capable of taking over the company since *December.*) Now, with the Arco bid on the table, it was possible to pursue a different strategy. It was possible to execute the maneuver known as "doing a Dome."*

James E. Lee

If no outside event intervened, Pickens's $65-a-share offer would probably attract a majority of Gulf's stock. It would then be possible to use the tendered securities as collateral for the loans that would be necessary to purchase it, since its true minimum value had been pegged at $70 a share by the Arco bid. Pickens could proceed according to the Gray proposal, gutting Gulf and selling off the pieces—but this bothersome procedure would also probably not be necessary. Not even Gulf could miss the message this time. To save itself from Pickens, it would have to sell itself immediately. And Pickens and his partners would make the money they had always known was there. Effortlessly.

It only remained to find the seed money needed to start buying. Drexel was ready with a candidate: the Penn Central Corporation, the diversified holding company that had emerged out of the wreckage of the Penn Central Railroad. Penn Central was controlled by Carl H. Lindner, yet another self-made man who gave no interviews, made a specialty of investing in undervalued companies, and was fond of distributing fourteen-karat-gold cuff links inscribed with such sentiments as "Only in America." In a complex deal involving subordinated notes, preferred stock, and stock warrants—in effect, options to buy more stock in the future—Penn Central gave Mesa $300 million. Pickens was ready to make his move.

On February 24, amid denunciations by Gulf that had taken on the character of incantation and ritual, the tender offer had begun. Lee called George Keller, Socal's chairman, and told him that Gulf had prepared briefing

**In the summer of 1981, indulging (or so it believed) in a spot of corporate blackmail, Canada's Dome Petroleum Ltd. tendered for 20 percent of Conoco Inc. Dome had no desire to own 20 percent of Conoco; it proposed to trade the stock for Conoco's Canadian subsidiary. Instead, Dome found itself awash in Conoco stock, with more than enough to take over the company. Conoco was forced to find a white knight (Du Pont), and lost its independent existence.*

books describing its reserves and other confidential matters. Socal could have access to them in exchange for assurances that it would not try to take over Gulf without Gulf's permission. Gulf stock was then trading at 62¼.

On February 27, word leaked out that Arco was preparing its formal bid and had engaged Chase Manhattan as lead bank in a $12 billion loan syndication—on paper, the loan would be the largest in history, although in constant 1969 dollars it would be worth about $4 billion. The Allied Corporation was interested enough to ponder Gulf's trading books, and GE, never a serious contender, was mentioned. Mobil was said to be in the running, and Socal's name appeared in the press for the first time. Amid heavy trading, Gulf stock hit 69½.

There were many stories, some of them true. The Kuwaitis were said to be interested in joining the fray; in all, seven companies were said to be poring over Gulf's trading books. Gulf stock briefly hit 71½ before falling back to 69. Someone, it was never clear who, began to buy heavily in Texaco, which had recently acquired Getty for a then record $10.1 billion. The Bass brothers of Fort Worth, who already owned 9.8 percent of Texaco, were suspected as the likely suspects, although the Basses, among the wealthiest men in America, traditionally invested for the long haul rather than the quick kill. But then, so did Penn Central's Lindner.

On March 1, Arco got its $12 billion as banks flocked from all over the world to join the syndication. Only a few months before, Morgan Stanley and Salomon Brothers had considered Gulf to be valued at $45 a share. Now, thanks to Boone Pickens, the financial analysts expressed dismay that Arco's bid was a mere $72 a share, up from the earlier bid of $70.

At Gulf, Mobil was out of the running; Kohlberg, Kravis, Roberts & Company, specialists in leveraged buy-outs, were in. The arbs began to move on Texaco. Reuters printed a rumor that the Basses had increased their holdings to 17.1 percent. Neither the brothers nor their father could be located. Pennzoil was with them, it was said; other rumors said it was Boone Pickens. Gulf stock reached 69½.

When the Gulf board met on the fifth morning in March, it had before it three firm offers. One, from Kohlberg, Kravis, Roberts, proposed a leveraged buy-out at $87.50 a share—$50 in cash and the balance in securities. Management would take the company private, pay off the debt by liquidating assets, and emerge with a handsome profit. Insiders reported that Harold Hammer was strongly in favor of the plan, feeling a leveraged buy-out, some said, was Hammer's motive in leaking the story to the *Times* about the Arco bid. But the KKR proposal had been hastily drawn, and it was late. A leveraged buy-out is usually one of the first options an attacked company considers, not one of the last; there were too many loose ends and too many uncertainties, and James Lee was not in favor of it. Hammer's plans had miscarried far too often. There would be no leveraged buy-out. The arguments dragged on. There were those who described Lee as a broken man.

There remained Arco's $12 billion and Socal's $13.2 billion. It was no contest. The previous went out from the board. Would the New York Stock Exchange suspend trading in Gulf?

George Keller and Lee made a joint announcement. Socal would buy Gulf at $80 a share. The new oil company, third largest in the nation, would be renamed Chevron, after the Socal trademark.

Boone Pickens and his partners had just made $760 million.

There would be no leveraged buy-out. The meeting of Gulf's board dragged on. There were those who described Lee as a broken man

NEW YORK. The Helmsley Palace Hotel. October 31, 1984.

"Here you had Gulf, a company that was very large, and Mesa, a company that was very small, and I saw very early on that Gulf's attitude was like flicking a fly," Boone Pickens was saying. His suite in the Helmsley Palace was done in pearl gray; the chaos of lunch remained on the table. "Their hostile attitude was immediately clear. As far as they were concerned, I had no business there. Well, we were stockholders. In fact we were the largest stockholders in the company by the time we were done."

As the Gulf deal wound down, Senators Howard Metzenbaum and J. Bennett Johnston, a liberal from Ohio and a well-known friend of the oil industry from Louisiana, respectively, proposed a six-month moratorium on large oil mergers, which would have left Gulf in a dangerous state of limbo, unable to plan or raise cash. Lee and his chief financial officer, James Murdy, hastened to Washington and begged not to be rescued, at least not like that. The moratorium was not imposed.

To decry the takeover Pickens forced is to misunderstand things. Unless it is destroyed, money never vanishes

The Federal Trade Commission gave the Gulf-Socal merger its blessing with a single dissenting vote. In return, the FTC insisted that Gulf divest itself of some thirty wholesale gasoline terminals and vacate its intetest in approximately 4,000 service stations in the Southeast. To avoid "anti-competitive effects" in the jet fuel industry, Gulf was ordered to sell either its refinery in Port Arthur, Texas (its largest), or the one at Alliance, Louisiana (its newest), and to find buyers for its 51 percent interest in the West Texas Pipeline and its 16.78 percent of the Colonial Pipeline. Until these transactions were completed, bringing in an estimated $1 billion, Gulf and Socal were to hold themselves separate.

For their part in the deal, Salomon Brothers and Merrill Lynch Capital Markets (brought in by Gulf in November) received $49 million, the largest fee ever paid to investment bankers in a takeover bid. Penn Central traded in its notes, stock, and warrants in Mesa for 14.5 million shares of Gulf, reaping a profit in the vicinity of $50 million. The Bass brothers, who had done precisely nothing, were bought out by Texaco for $1.28 billion, at a premium of $5 a share.

At Gulf, a great many people made a great deal of money, but nothing else of importance happened. Legislation was eventually passed making royalty trusts an unprofitable way of hiding money, but that was inevitable once the concept was explained to the relevant legislators; just as nature abhors a vacuum, Congress, in a time of record deficits, detests a tax dodge. A number of Gulf employees were certain to lose their jobs, but there was nothing new in that; James Lee had begun the dismissals, and he had resumed them after the December proxy fight. Gulf lost its independence but it did not go out of existence. It simply went somewhere else; its wells and refineries were not destroyed. Gulf's executives had their golden parachutes, and at least some of them became rich. From stock options alone, Lee was entitled to receive $6,715,000, a figure that was to be doubled by Chevron.

Months after the deal was closed and their company was well on its way to oblivion, the men at Gulf still seemed unable to see Boone Pickens clearly. "The guy is a failure in the oil and gas business," said James Murdy. "He put together a company, Mesa, and I give him credit for that. But he can't deal with the oil environment since 1976, and I think he knows it. He has a totally demoralized organization. He even forced his employees to build him a statue, which I think is a nice thing to do. Play golf with him if you want to find out what kind of a sport he is."

Pickens, as usual, had his own perspective. "Listen," he said, "we did Gulf a favor if they thought they'd find oil north of the Barrow Arch. I knew more about the drilling on Cross Island than Jimmy Lee did. He was crazy if he had that kind of dream. They just didn't have anything else to do with the money, and the last thing managements like that think of is sharing with the stockholders. That's what you get down to.

"Gulf kept saying what an awful guy Pickens was, at the same time they were saying what a terrific job they did for their stockholders," Pickens continued. "They keep saying that they won, we lost. That dog won't hunt. All this management was ever able to do, in the red-hot market of 1981, was get the stock up to 53. When we bought our first share, it was 37. They sold out to Chevron for 80. In their whole lives they could never have gotten it to 80; I don't think they could have gotten it to 53 again. Lee told me on February 6 that he wanted two more years. He thought he could get the price up to 60 or 65. I shook my head and wondered if I'd dozed off and missed part of the conversation. He had an offer from Arco for 70 on the table, and I asked him about it. You know what he said? He said, 'I was afraid you were going to ask that.' "

As might be expected, the commentators decried the colossal waste of it all, the feverish shifting of money from one pocket to another, the stupendous fees, the misdeployment of bank funds that might otherwise have been used for some noble social purpose. This is to misunderstand the processes at work. Unless it is destroyed, money never vanishes. By far the greatest portion of it returns to the economy, and thanks to Pickens, there is quite a lot more of it than there was before he set to work. ■

Senator D'AMATO. Thank you very much, Mr. Hartley. We could get into some tariff questions later and I'd enjoy that, but I'm going to yield now for purposes of an introduction to my colleague, the gentleman from Texas.

Senator GRAMM. Thank you, Mr. Chairman. I'm happy to have an opportunity to introduce a fellow Texan who's here today, a friend of mine, who I believe has brought a new focus of attention back to corporate America, and that focus of attention is the people who invest their money, the stockholders.

When I studied economics in college, a subject that I later taught, I was taught that the corporation worked as a democracy, the people voted with their shares. I am alarmed to hear people who built financial empires talk about a proposal that if enacted 30 years ago would have made the building of major corporations in America virtually impossible, and I'm happy to have an opportunity for this committee to let people hear all sides of that question.

I believe it's important that we protect our financial institutions. I believe it's important that we have an orderly financial process. I think it's vitally important that we let the market work. The market works not just at the dime store where people buy or don't buy something and therefore kill off companies that are not efficient. Companies do not cease to be when they are bought by other managements nor do tools cease to exist when the company that is using them finds they couldn't use them properly. They are simply reallocated to somebody who can use them better. If companies cannot operate at a profit, if companies cannot defend themselves from those who are coming in and buying up their shares, then we ought to shift the mantle of management.

How we protect the public's interest in financial institutions, that's a question that clearly is within the jurisdiction of this committee. But the idea that we ought to end the process, that we ought to endow with a permanent Government-protected ironclad contract every manager with a lifetime guarantee is something that I simply find wrong.

Senator D'AMATO. Is that the introduction?

Senator GRAMM. Yes.

Mr. HARTLEY. May I comment on that, sir?

Senator D'AMATO. No, no; Mr. Hartley, we will have ample opportunity for discussion.

Mr. Pickens.

STATEMENT OF T. BOONE PICKENS, JR., PRESIDENT AND CHAIRMAN OF THE BOARD, MESA PETROLEUM CO.

Mr. PICKENS. I am Boone Pickens, chairman of Mesa Petroleum and I appreciate the opportunity to appear before you today. I request that the full text of my remarks be submitted for the record.

I believe the stockholders own the companies and they have a right to decide what happens to companies. I don't believe we should have management standing between stockholders and an offer, for instance. I think if the risk is taken by stockholders they should decide whether they want to tender or whether they want to take an offer or not.

DON'T FURTHER ENTRENCH MANAGEMENT

Congress should not take any action to further entrench entrenched management. We criticize big business in America sometimes for good reason, so why fortify management that has done a poor job?

If you disallow the use of high-yield bonds you make it more difficult for a smaller company to finance a tender offer for a larger company. Such action further entrenches management and gives big business all the defenses.

Management works for the stockholders, just as you work for the voters. The 42 million stockholders in America, which is 100,000 per congressional district, can't stand any more abuse. These people have put their money at risk. Don't play games with them. Don't declare a moratorium or take any other action that would add greater risk to stockholder investment or deny them a chance to make a decent profit. Thank you.

[The complete prepared statement follows:]

STATEMENT OF T. B. PICKENS, JR.

PRESIDENT AND CHAIRMAN OF THE BOARD

MESA PETROLEUM CO.

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON SECURITIES

HEARING ON CORPORATE TAKEOVERS

June 12, 1985

My name is T. Boone Pickens. I am President and Chairman of the Board of Mesa Petroleum Company. I appreciate the opportunity to appear before this Committee to discuss corporate tender offer and takeover legislation.

This is the eleventh time I've appeared before a Congressional committee since March 15, 1984. The complete record of my testimony alone fills two large volumes back in my office. The record of these Committees' deliberations, of course, is quite lengthy. However, despite this exhaustive review by Congress and the existence of dozens of bills designed to curb takeover activity, neither the House nor the Senate has passed Williams Act revisions regarding takeovers in the last two years.

I know it hasn't been my testimony that has caused this result, although for some time there were few who were willing to agree publicly with me. But I am far from alone now in professing my confidence in our capital markets and in the proposition that shareholders are the cornerstone of our free enterprise

system. For example, respected academicians from Harvard University, UCLA and Emory, the editorial pages of the Wall Street Journal and the New York Times, and the chief economists at the SEC all seem to agree: the problem afflicting corporate America is not too many takeovers but too many entrenched managers who ignore the interests of shareholders. No single theme has been more often repeated during the long course of Congressional deliberations on these issues than this one.

I am a geologist from Amarillo, Texas, who had an idea on how to improve the return on my shareholders' investments. My success has depended upon a commitment to the principle that shareholders are the linchpin of our free enterprise system. That principle has been put to the test recently by Congress and the courts. To your credit, you have resisted the temptation to overturn it. One court in Delaware failed the test, but I still have confidence that balance will be restored to the system and to our capital markets.

Some people might ask if I have lost faith in a free and open capital market after the Delaware Supreme Court decision regarding Unocal. However, the market, even in the distorted way it was allowed to operate, confirmed our belief that Unocal's shareholders were not receiving full value for their investment and that the management of Unocal could do a better job in working for its shareholders. As a result of our efforts, 120,000

Unocal shareholders received an additional $1.7 billion return on their investment.

Moreover, in the course of the major transactions in which we have been involved, 950,000 shareholders have made $16 billion. That's a record I'm proud of.

The lesson of the Unocal experience is not that the capital markets are inefficient, but that it's still possible for management to break one of the cardinal rules of corporate law. That rule was best stated by the SEC in 1979 in proposing a regulation to ensure equal treatment of shareholders:

> Current tender offer practice thus reflects a common understanding that implicit in the Williams Act is a requirement that a tender offer be made to all security holders. The Congressional purpose underlying the Williams Act was to require fair and equal treatment of all holders of the class of security which is the subject of a tender offer. Moreover, the operation as well as the legislative history of certain substantive provisions of the Williams Act contemplate that the tender offer will be made to all holders of the class being sought.

One of the reasons this rule was not adopted was the feeling that courts would always uphold this "common understanding."

I worry that this decision, if left uncorrected, will deter other shareholders from challenging management in the future and will deprive shareholders and the economy of the benefits of takeovers. Certainly, corporate governance has sustained a painful blow; we must make sure that it is revived and rejuvenated so that the confidence of the American investor is maintained.

Despite the need to correct this damage inflicted upon shareholder interests, I urge the Committee to review the complex issues of takeovers and their impact on the economy in a comprehensive and deliberate manner. Many in the business community, especially investors, have been concerned that drastic prophylactic "solutions" concerning takeovers have been offered, and will continue to be offered, in this session of Congress, as hostile battles for control of major corporations continue to perk the interest of the news media and the general public.

Historically, Congress has recognized that economic distortions caused by the legislative imposition of unnecessary artificial barriers on U.S. capital markets are not in the public interest. I am concerned that the move by some for sweeping changes is fueled by emotion concerning individual cases. The result of such changes would be uncertainty and damage to our securities markets, which provide hundreds of billions of dollars in debt and equity capital to corporations annually and are by far the best markets in the world.

We must remember that the ability to raise capital, which creates jobs for our workforce and products and services for consumers, is dependent upon maintaining the confidence of the investing public. Forty-two million Americans own stock in our public corporations, according to a 1983 New York Stock Exchange survey. That is one out of every six, or more than 100,000 voters in each Congressional district in the United States.

About half of these people have portfolios of less than five thousand dollars. They have risked their money with the expectation that they would be treated fairly and would have access to all material information necessary to make rational investment decisions. Under state and federal law, owners of corporate securities have certain rights. Among these are the rights to participate in corporate governance and to sell their securities to a willing buyer offering the highest price. Restrictions on legitimate offers to buy securities would deprive investors of a basic property right and would seriously erode public confidence and the liquidity of our markets.

In expressing concern over the plight of the shareholder, Mr. Robert Bleiberg asks "Who speaks for the silent majority?"1/ Mr. Chairman, in this capitalistic society the shafeholder is our constituent, just as the voter is your constituent. We listen to our constituents. We work for them. We try hard to increase the value of their investment in Mesa and, if we fail, we expect to be voted out of office, just as you do.

MESA PETROLEUM -- A COMPANY RESPONSIVE TO ITS SHAREHOLDERS

As a background for my remarks concerning the Committee's specific areas of inquiry, perhaps it would be helpful for me to discuss the history and philosophy of Mesa Petroleum.

1/ Barrons, January 14, 1985.

Petroleum Exploration Inc., the predecessor company of Mesa, was capitalized with $2,500 in 1956. The name was changed to Mesa Petroleum Co. in 1964, and we became a public corporation at that time with total assets of less than $2 million. Five years later, we tendered for and acquired another public corporation engaged in the production of hydrocarbons. This company was twenty times the size of Mesa. It had large gas reserves, considerable cash flow and no exploration staff. It was destined to deplete its reserves in a matter of years, which meant the stockholders would deplete their assets and income while the employees ended up with no jobs.

This company was quickly assimilated into Mesa where the cash flow was directed to expanding our exploration activities, employing highly competent personnel and building the reserve base for our shareholders. Three years later, acting as a white knight, we acquired another energy company and the procedure was repeated. In each instance, efficiencies of operation were greatly improved and return on shareholders' investments was enhanced. No people were laid off. Only a handful of the acquired companies' employees declined new job offers with Mesa.

Also, in each instance, the shareholders of the newly acquired companies who elected to take Mesa stock in exchange for their original shares enjoyed significant appreciation in both market value and asset value.

We proved that through acquisitions, a larger, more profitable and vital company could emerge. We also demonstrated that through expanded exploration budgets made possible by the larger cash flows and borrowing base of the combined companies, more oil and gas could be found.

Each year since its inception, Mesa has replaced and enhanced its reserve base. Replacement has been achieved primarily through intensive exploration and development. We have invested over $1.8 billion in offshore exploration and development in the Outer Continental Shelf and have an average interest of 30 percent in 50 offshore platforms. During the last five years, total additions to Mesa's liquid reserves represented 139 percent of production and additions to natural gas reserves represented 187 percent of production. Our total assets today are approximately $4 billion and our net income last year was $254 million on revenues of $413 million.

In 1981, our capital budget was $420 million; this sum was considerably in excess of our cash flow. In 1982, the budget was $320 million, in 1983 it was $223 million, and the 1984 budget was $110 million, excluding the $500 million purchase of proved reserves. The 1985 budget is $75 million. This current budget represents about one third of our cash flow, which percentage is consistent with practice in the industry. Our decision to bring capital expenditures in line with cash flows was a calculated decision based upon our concern over the near-term future of the

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oil and gas business. It had no relation to our having created royalty trusts or our having invested in other energy companies.

The most recent data covering the Fortune 500 companies shows that Mesa would be included in the top five energy companies in assets and net income per employee, and in net income as a percent of stockholders' equity. An investor who purchased 1,000 shares of Mesa for $10,000 when the company was founded in 1964, as a result of the stock splits and the creation of two royalty trusts, would now have an investment with a market value of approximately $312,000.

That is hardly the record of a liquidator.

CORPORATE ACCOUNTABILITY

Oftentimes a takeover is the only way, or at least the quickest way, of dislodging a management that is unresponsive to market developments and therefore unresponsive to shareholders. Management efficiency can arise from better utilization of the acquired firm's resources. Management can lose its competitive edge to the luxuries of perceived success -- ever growing perquisites and excessive free time away from company matters. Whatever the reason, it is important that stockholders not be burdened with a management that cannot face up to or handle current problems.

The mere threat of a hostile takeover attempt can perform a desirable disciplinary function and fosters enhanced corporate

accountability to the shareholders. Management must never be allowed to become complacent or to forget who really owns the corporation. One commentator has asserted that the "market for corporate control may be the only serious force for limiting management discretion."2/

In my view, the Economic Report of the President, on page 189, states the case succinctly and correctly:

> The best assurance an incumbent management has against a successful takeover attempt is a stock price that is high relative to outsiders' estimates of the potential value of the corporation's shares. Managements that allocate capital to higher valued uses, operate efficiently, and adopt capitalization structures responsive to prevailing financial market conditions are less likely to be subject to takeover than other management groups. Consequently, in order to prevail in the external market for corporate control, it is not enough that an incumbent management believes that it is doing a proper job, or that it persuades stockholders that it is doing so. Instead management must demonstrate that its performance is competitive with the performance of other potential managers, and the value of management's performance must be reflected in the corporation's stock price.

The Economic Report concludes:

> The public has a legitimate interest in the continued strength and vitality of the market for corporate control. Publicly traded corporations account for a substantial portion of the Nation's wealth and productive capacity, and it is important that the management

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2/ Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 841 (1981).

> of these firms not be insulated from competition in the market for corporate control. The available evidence is that the operation of this market has generated net benefits for the economy. The evidence also suggests that abusive practices in the market for corporate control are limited largely to tactics employed by target managements who, in opposing takeover bids, defeat or deter tender offers at the expense of their stockholders and the economy.
>
> Remedies for these abuses can often be fashioned within the corporation itself. Stockholders also have recourse to the courts which have recently indicated a willingness to subject target management conduct to closer scrutiny. In addition, abusive conduct by corporate management has traditionally been subject to State regulation; the available evidence indicates that federalism has served stockholders well. Accordingly, further Federal regulation of the market for corporate control would be premature, unnecessary, and unwise. (Emphasis added.)

RESTRUCTURING THE ENERGY BUSINESS -- CORPORATE TAKEOVERS ARE NOT THE PROBLEM, BUT A RESPONSE TO THE PROBLEMS IN THE INDUSTRY

Merger and acquisition activity is good for the economy, shareholders and consumers. Such activity is not itself a problem, but a response to fundamental shifts in our economy. In other words, this is a natural function of the free market, and left untampered with, it will produce great benefits. In no industry is this more true than in the energy business, with which I am most familiar.

The oil industry is in the process of being restructured so that it can provide more cost-effective products to consumers and

greater returns to investors. In the February 21, 1985 Wall Street Journal, John C. Sawhill, speaking to the urgent need for managements in the oil industry to address unprofitable downstream operations by restructuring their companies, reasons that:

> Consumers will benefit from a restructuring of the oil industry in two ways. First, oil product prices will tend to fall, perhaps as much as five cents a gallon, as less efficient refining operations are shut down and those that remain operate at higher capacity. Natural gas prices should also fall as gas companies respond to the competition from oil. The second benefit is likely to be increased supply security. Oil producing countries that are tied into downstream operations will have less incentive and flexibility to purposely disrupt oil flows.

We have been identified as a "sunset" industry because of the inability to replace reserves at a reasonable cost. The continual deterioration of the price of oil and gas in a world of oversupply has compounded the problem.

Who cares that a given company is not replacing its reserves? Who does it hurt? The answer is quite simple -- consumers in America and the shareholders of that company have great reason for concern. When a company doesn't replace its reserves, the shareholders' asset base is being eroded. Under those circumstances, if management knows it cannot replace annually, then it must see that the shareholders receive value for those eroding assets. Gulf Corporation and Phillips Petroleum Company are two examples of companies whose replacement ratios were of concern to stockholders. Gulf had only replaced through

exploration 45 percent of the domestic equivalent oil and gas reserves it had produced from 1980 to 1983. Phillips had only replaced 36 percent of its domestic equivalent oil and gas reserves through exploration during that same time period.

If management is innovative and sound, it can still realize tremendous values, enhance profitability and return value to shareholders. Unfortunately for many shareholders the ingenuity and guts of many managements have yet to surface.

Today, stockholders are concerned over the asset erosion and the impact this erosion has on their investment. Restructuring is one method of coping with the problem. Russell E. Miller of Alex. Brown & Sons, Inc. has produced a comprehensive report, Restructuring the Oil Industry 1980-85. Mr. Miller accurately notes:

> The oil industry is in the process of being restructured so that it can provide more cost-effective products to customers and greater return to investors. But restructuring is the management of major assets in a variety of ways, including takeovers, asset spin-offs, royalty trust distribution, "token" trust distributions, and asset sales together with aggressive stock repurchase programs . . . . We think that virtually no oil company management, regardless of the size of the company, can be immune to the shareholder pressure to restructure.

In our opinion, Mr. Miller's analysis is entirely correct. It will take creative managers, who are themselves stockholders, to solve problems perplexing this industry. The professional manager who owns little stock in his company will have little

empathy for investors when his first concern may be preserving his employment.

It should surprise no one that, in some instances, large stockholders have taken it upon themselves to force management to take action. That is what occurred at Getty, Gulf and Superior, and in such cases shareholder wealth increased. If management is unwilling to allow shareholders the opportunity to benefit from the untapped value of the company's assets, it is time for a change.

But it should not take the impatience of large shareholders to wake up management. The energy industry must take steps now to avoid becoming the equivalent of the steel industry of the 1990s. I am encouraged that we are starting to take these steps. John Sawhill made this same point in the May 5, 1985 New York Times when he examined Atlantic Richfield's plans to restructure. As he correctly observed, managers who feel threatened by takeovers have a broad range of options that are not limited to "short-term fixes." But clearly the handwriting is on the wall, as Mr. Sawhill explained:

> The energy industry today is facing difficult but not intractable problems. Deregulation, falling oil and gas prices and declining demand have created overcapacity in almost every part of the business. Management has to respond to these changes with something more than business as usual.

Unfortunately, when some managements recognize that shareholders are beginning to exercise their right to question

management decisions, the corporations' response has been less than admirable. In an effort to insulate themselves from this perceived problem, these managements are instituting entrenchment devices, like the poison pill. Poison pills arbitrarily take away shareholder rights without giving such shareholders the opportunity to vote on the issue. Managements further insulate themselves and defend actions by hiding behind the business judgment rule.

TAKEOVERS DO NOT HARM THE ECONOMY --
THEY CREATE BENEFITS

In the November-December 1984 issue of the Harvard Business Review, Professor Michael Jensen, who is one of the foremost academicians studying mergers and acquisitions, finds that corporate takeovers convey wealth to shareholders and use assets efficiently. He states that, "Corporate takeovers do not waste resources; they use assets productively. Takeovers do not siphon commercial credit from its uses in funding new plants and equipment." (The full text of the Jensen article is attached).

The Senate Committee on Energy and Natural Resources studied this issue extensively last year. ("Impact of Oil Company Mergers", Report to the United States Senate, prepared by the Majority Staff of the Committee on Energy and Natural Resources, United States Senate, July 1984.) Permit me to quote from some of the conclusions of the Majority Staff's report:

> [T]he acquisition of one company by another is purely a financial transaction. One type of

> financial asset is exchanged for another. Cash is exchanged for the equity shares of the acquired company, and the equity shares represent ownership of existing capital. A merger or acquisition does not create a new addition to total outstanding credit, as contrasted to borrowing cash to acquire real new capital, such as a new manufacturing plant. (p. 19)
>
> Thus, the borrowing required for a corporate acquisition does not impose net new credit demands on the system, and it does not withhold credit from competing borrowers. The reason is the fact that the shareholders of the acquired company invariably reinvest the proceeds from the sale of their equity shares. Such investment injects the funds back into the credit markets, either directly through an institution that lends the invested funds, or indirectly through investments in securities that displace borrowed funds. The fungibility of money assures that the investments by the shareholders of the acquired company will flow back into the money markets or capital markets where they would be available to finance credit needs. (p. 19)

Professor Jensen also labels as "folklore" the notion that shareholders are somehow harmed by takeovers. He found that target company shareholders gain 30 percent from tender offers and 20 percent from mergers. Target shareholders also were shown to gain 8 percent from proxy contests. Contrary to another myth, Jensen indicates that the shareholders of acquiring companies gain about 4 percent from tender offers and suffer no harm from mergers.

On a more general basis, the matter of whether shareholders benefit from the tender offer process was discussed by Frank Easterbrook and Gregg Jarrell, members of the SEC Advisory Committee on Tender Offers, in their statement attached to the

Advisory Committee's report. Their statement made the following observations:

> We start from the position, backed up by evidence detailed in the Appendix, that tender offers benefit shareholders of both bidders and targets. The premiums paid to targets do not just come out of the hide of bidders' stockholders; there is a gain when the bidders and targets are evaluated as a unit. (p. 2)
>
> The premiums reflect real gains to society as well as investors. Stock prices reflect the anticipated future dividends of the stock (including profits distributed in any "final" dividend, such as the payment accompanying a merger). Profits and dividends, in turn, increase when a firm becomes more efficient or better at producing what consumers want to buy. Higher stock prices thus are based on social as well as private gains. Perhaps the gains observed in tender offers come from the fact that bidders' managers make more efficient use of the targets' resources than the targets' managers do. (p. 3)

Mesa's own experience is quite positive. Shareholders of companies Mesa has sought to acquire as well as Mesa's shareholders have benefitted from the tender offer process. The following analysis, which includes two of the tender offers Mesa has been involved in as well as one in which Mesa was not involved as an offeror, clearly demonstrates the gain in value to shareholders.

ANALYSIS OF SELECTED MERGERS

	J. S. Herold Value Per Share	Pre-Merger Price Per Share	Stock Price All-Time High (Year)	Offer Price Per Share	Price Per Share Achieved	Percentage Increase Over Pre-Merger Price	Number of Shareholders	Gain to Shareholders (In Millions)	Gain to Mesa	Federal Income Taxes
Cities Service	$ 97	$ 30	$ 68 (1981)	$ 45 (Mesa)	$ 52	73%	150,000	$ 2,000	$ 32	$ 600
Gulf	$114	$ 40	$ 54 (1980)	$ 65 (Mesa)	$ 80	100%	400,000	$ 6,600	$404	$2,000
Getty	$153	$ 69	$109 (1980)	$128 (Texaco)	$128	86%	30,000	$ 4,700	N/A	$1,600
Phillips	$ 79	$ 35	$ 63 (1980)	$ 60 (Mesa)	$ 53	51%	200,000	$ 2,790	$ 89	$ 837
TOTALS							780,000	$16,090		$5,037

HIGH YIELD BONDS INCREASE COMPETITION AND IMPROVE ECONOMIC GROWTH

Recently, a great debate has ensued over the economic benefits of high yield securities in the context of hostile corporate takeovers. The misconceptions which have dominated this debate need to be addressed, and the importance of these securities to the business community need to be highlighted.

High yield securities, pejoratively called "junk bonds," are commonly defined as all issues rated below "investment grade." -- those which are rated Bal or lower by Moody's, BB+ or lower by Standard & Poor's, or unrated. High yield securities produce relatively high interest which is to a certain extent indicative of their higher risk of default. There is no question, however, that the greater the risk, the greater the potential return.

It should be noted that bonds originally issued as investment grade become high yield when they are downgraded and traded at discount, reflecting their issuer's business reverses. Bonds can also be issued at high yields if their issuer is too new to qualify for investment grade status.

The important fact to remember is that over 85 percent of all U.S. public companies would be rated at below investment grade if they sought a rating. Some of our country's fastest growing and best known companies at one time fell into this category. Examples of companies which began as high yield issuers included American Airlines, Eastern Airlines, Pan Am, TWA,

United, Firestone, Goodyear, Goodrich, and many other companies such as Warner Brothers, MCI, United Brands and Pennsylvania Power and Light, to name a few.

High yield bonds have also facilitated many recent "going private" transactions. Taking that route in recent years have been such well-known companies as After Six, American Financial, CCI, Cole National, Condec, MacAndrews & Forbes, Metromedia, Midland Glass, Puritan Fashions, Rapid-American, Reliance Group, SFN Companies, and Twentieth Century-Fox Film. In many of these cases, the sale of assets not required to run the business has kept leverage from increasing substantially. More importantly, the new owners typically have an equity participation and therefore have a greater incentive to perform. Thus far, none of the companies which have gone private has missed an interest or principal payment on its public debt.

These are the types of companies which have been responsible for 80 percent of all job formation in the United States. Without the ability to sell high yield, low rated bonds, many of these small companies would be denied access to the public capital markets and would be burdened with higher interest rate financing.

High yield debt financing has strengthened the discipline of the marketplace by making size less of an impediment to acquisition activity. Previously, sheer size had prevented economically

valuable acquisitions and protected large companies from acquisition by smaller companies, even if incumbent management was doing a poor job for shareholders. The amount of capital required for an acquisition made mounting a competitive challenge impossible for all but another large company (which frequently would be deterred by antitrust considerations). Indeed, the absence of a high yield bond market to finance corporate takeovers would result in a system where, for example, Mesa could have been taken over by a Unocal; however, a Mesa acquisition of Unocal would be virtually impossible. This anomalous result would be protection for an arrogant entrenched manager and yet another nail in the coffin for shareholders. As the New York Times recently editorialized:

> Some of America's largest corporations have been badly managed and have not been accountable to anyone. Stockholders have had to take it, or sell out. But the real threat of takeovers is to shift the balance of power back toward the owners. If raiders are denied the option of junk-bond financing, mediocre managers will be that much safer and less accountable.

Although high yield bonds have facilitated some acquisitions, it is easy to exaggerate their role in hostile takeovers and to ignore their benefits. Only about 12 percent of the new high yield debt issued in 1984 was issued in connection with acquisitions, and only 2 percent in connection with hostile acquisitions.

High yield bonds have made an important contribution to acquisition activity by making capital available to finance acquisitions of the largest companies. As previously mentioned, mere size had once prohibited economically advantageous acquisitions because of the amount of capital required to finance such transactions. Through the high yield bond market, smaller companies, which are an essential source of new ideas, more vigorous management and new job formation, can now raise the capital necessary to expand through internal growth and acquisitions.

CONCLUSION

In your deliberations over merger and tender offer policy, I would urge you to remember that shareholders are the cornerstone of our free enterprise system. Intricately involved in this system are the consumer who benefits from efficient management and the people who are employed by those business ventures which succeed.

Entrenched managements are not accountable to shareholders. If shareholders rights are removed, equity securities will no longer be as attractive for investment purposes. Once the confidence of investors is weakened, equity markets will deteriorate to the detriment of capital formation and the free market system.

A recent cover story in the May 27th issue of Fortune concluded:

> A free and fluid market for corporate control is an essential ingredient of a sound economy. Any additional limits on takeovers would simply lock up assets in inefficient uses and do what the antitakeover forces say they fear -- frustrate innovation, reduce competitiveness, and lead to a lower standard of living.

Congress would be wise to heed these words. At a time when the ability of the U.S. to compete in world markets is under intense pressure from other industrialized nations, policies that might have the effect of undermining the liquidity of our capital markets must be avoided.

Investors look to government to preserve fairness and at the same time to preserve our free market.

Public criticism of the takeover market is largely unfounded and unproductive

Takeovers: folklore and science

Michael C. Jensen *

Criticism of the increasing number and complex collection of mergers, tender offers, leveraged buy outs, and proxy offerings has come from consumers, government, and business. The general negative reaction focuses on the amount of money involved and the complex managerial maneuvering among industrial giants.

In the view of some financial economists, however, corporate takeovers are the logical outgrowth of competitive struggles in the free market. If you accept the assumption that shareholders are the most important constituency of the modern corporation, then these mergers and acquisitions make sense because they increase the value of the shares held in the target company.

Michael Jensen, one of the foremost proponents of this argument, has examined the various criticisms of corporate takeover activity and found many to be based on faulty logic. His conclusions are as controversial as the subject: takeovers are good for shareholders, golden parachutes are not unreasonable, mergers do not create monopoly power, takeovers serve a unique economic function. Whether you accept the underlying basis of his assertions, you will find them fascinating, for they bring the discussion out of the realm of prejudice. At the very least, they serve as a logical basis for realistic further investigation.

Mr. Jensen is LaClare Professor of Finance and Business Administration at the Graduate School of Management, University of Rochester, founder and director of the Managerial Economics Research Center, and founding editor of the Journal of Financial Economics. *During the academic year 1984-1985, he is visiting professor at the Harvard Business School. He is the author of numerous articles and editor of several books, including (with Clifford W. Smith, Jr.)* The Modern Theory of Corporate Finance *(McGraw-Hill, 1984).*

Illustration by Karen Watson.

From 1981 to 1983, the number of large U.S. corporate acquisitions grew at a rate roughly double that of the 1970s and even exceeded the one realized during the famous merger wave of the 1960s. The drama of 2,100 annual takeovers valued at more than $1 million – much of it played out in heated, public battles – has generated an enormous amount of criticism, not only from politicians and the media but also from high-level corporate executives.

Commenting in the *Wall Street Journal* on the Bendix and Martin Marietta takeover battle, for example, Lee Iacocca, chairman of Chrysler, argued:

"It's not a merger. It's a three-ring circus. If they're really concerned about America, they'd stop it right now. It's no good for the economy. It wrecks it. If I were in the banking system I'd say no more [money] for conglomerates for one year."

A former director at Bendix added:

"I think...it's the kind of thing corporate America ought not to do, because the poor stockholder is the one whose interest is being ignored in favor of the egos of directors and executives. And who the hell is running the show – the business of making brakes and aerospace equipment – while all of this is going on?"

In a 1984 *New York Times* piece on the "surge of corporate mergers," Felix Rohatyn noted:

"All this frenzy may be good for investment bankers now, but it's not good for the country or investment bankers in the long run. We seem to be living in a 1920s, jazz age atmosphere."

Just as the public outcry over excesses on Wall Street in the early 1930s led to the Glass-

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Editor's note. All references are listed at the end of the article.

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Steagall Act regulating banking, so the latest criticisms of mergers have brought enormous political pressure to bear on Congress to restrict takeovers. The July 1983 report of the SEC Advisory Committee on Tender Offers contained 50 recommendations for new regulations. Democratic Representative Peter Rodino has cosponsored a bill that would require advance notice of proposed acquisitions resulting in assets of $5 billion and 25,000 employees and a judgment by the Antitrust Division of the Justice Department or the FTC whether such acquisitions "serve the public interest."

The popular view underlying these proposals is wrong, however, because it ignores the fundamental economic function that takeover activities serve. In the corporate takeover market, management teams compete for the right to control – that is, to manage – corporate resources. Viewed in this way, the market for control is an important part of the managerial labor market, which is very different from, and has higher stakes than, the normal labor market. After all, potential chief executive officers do not simply leave their applications with personnel officers. Their on-the-job performance is subject not only to the normal internal control mechanisms of their organizations but also to the scrutiny of the external market for control.

Imagine that you are the president of a large billion-dollar corporation. Suddenly another management team threatens your job and prestige by trying to buy your company's stock. The whole world watches your performance. Putting yourself in this situation leads to a better understanding of the reasons behind the rhetoric, maneuverings, and even lobbying in the political and regulatory sectors by managers for protection from unfriendly offers.

The Bendix attempt to take control of Martin Marietta in 1982 gained considerable attention because of Marietta's unusual countertakeover offer for Bendix, called the "Pac-Man defense," whose principle is "My company will eat yours before yours eats mine." Some describe this kind of contest as disgraceful. I find it fascinating because it makes clear that the crucial issue is not whether the two companies will merge but which managers will be in control.

At the end of the contest, Bendix held 67% of Martin Marietta while Martin Marietta held 50% of Bendix. United Technologies then entered as Martin Marietta's friend and offered to buy Bendix. But it was Allied, coming in late, that finally won the battle with its purchase of all of Bendix's stock, 39% of Martin Marietta's, and a promise not to buy more. When the dust had cleared, shareholders of Bendix and Martin had both won: their respective shares gained roughly 38% in value (after adjusting for marketwide stock price change). Allied's shareholders, on the other hand, lost approximately 8.6%.

Given the success and history of the modern corporation, it is surprising how little the media, the legal and political communities, and even business executives understand the reasons behind the complexities and subtleties of takeover battles. Prior to the last decade, the academic community made little progress in redressing this lack of understanding. But research efforts in business schools across the country have recently begun to overcome it.

In this article I summarize the most important scientific evidence refuting the myths that swirl around the controversy. The research shows that:

- Takeovers of companies by outsiders do not harm shareholders of the target company; in fact, they gain substantial wealth.
- Corporate takeovers do not waste resources; they use assets productively.
- Takeovers do not siphon commercial credit from its uses in funding new plant and equipment.
- Takeovers do not create gains for shareholders through creation of monopoly power.
- Prohibition of plant closings, layoffs, and dismissals following takeovers would reduce market efficiency and lower aggregate living standards.
- Although managers are self-interested, the environment in which they operate gives them relatively little leeway to feather their nests at shareholders' expense. Corporate control-related actions of managers do not generally harm shareholders, but actions that eliminate actual or potential takeover bids are most suspect as exceptions to this rule.
- Golden parachutes for top-level executives are, in principle, in the interest of shareholders. Although the practice can be abused, the evidence indicates that shareholders gain when golden parachutes are adopted.
- In general, the activities of takeover specialists benefit shareholders.

Before exploring the evidence, I consider why shareholders are the most important constituency of the modern corporation and why their interests must be held paramount when discussing the current wave of acquisitions and mergers.

The nature of the corporation

Stockholders are commonly portrayed as one group in a set of equal constituencies, or "stakeholders," of the company. In fact, stockholders are *not* equal with these other groups because they are the

ultimate holders of the rights to organization control and therefore must be the focal point for any discussion concerning it.

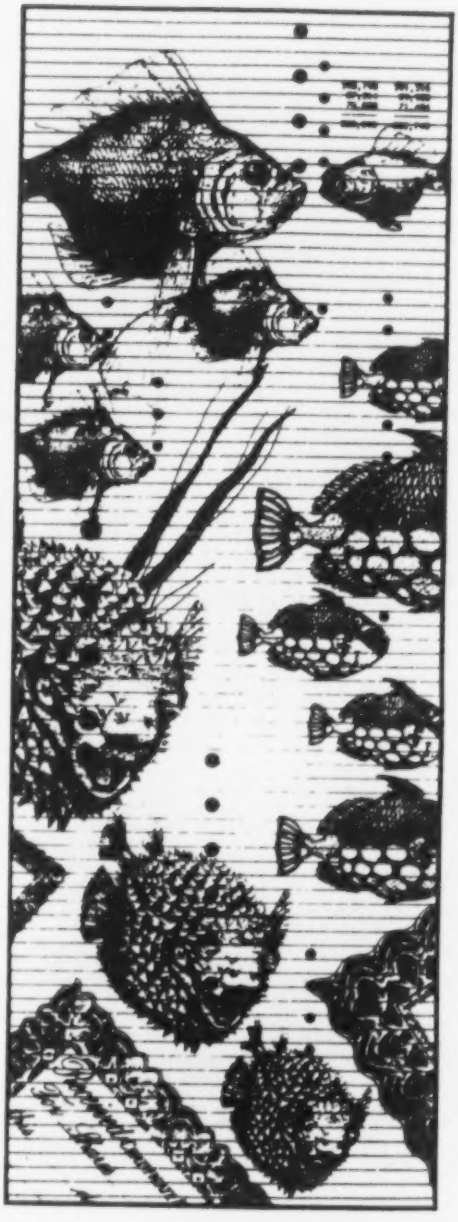
The public corporation is the nexus for a complex set of voluntary contracts among customers, workers, managers, and the suppliers of materials, capital, and risk bearing. The rights of the interacting parties are determined by law, the corporation's charter, and the implicit and explicit contracts with each individual.

Corporations, like all organizations, vest control rights in the constituency bearing the residual risk. [Residual risk is the risk associated with the difference between the random cash inflows and outflows of the organization.] In partnerships and privately held companies, for example, these residual claims and the organizational control rights are restricted to major decision agents (directors and managers); in mutuals and consumer cooperatives, to customers; and in supplier cooperatives, to suppliers.

Corporations are unique organizations because they make no restrictions on who can own their residual claims and this makes it possible for customers, managers, labor, and suppliers to avoid bearing any of the corporate residual risk. Because stockholders guarantee the contracts of all constituents, they bear the corporation's residual risk. The absence of restrictions on who can own corporate residual claims allows specialization in risk bearing by those investors who are most adept at the function. As a result, the corporation realizes great efficiencies in risk bearing that reduce costs substantially and allow it to meet market demand more efficiently than other organizations.

Although the identities of the bearers of residual risk may differ, all business organizations vest organizational control rights in them. For control to rest in any other group would be equivalent to allowing that group to "play poker" with someone else's money and would create inefficiencies that lead to the possibility of failure. Stockholders as the bearers of residual risk hold the right to control of the corporation, although they delegate much of this control to a board of directors who normally hire, fire, and set the compensation of at least the CEO.

Proof of the efficiency of the corporate organizational form shows dramatically in market performance. In principle, any marketer can supply goods and services. In reality, all organizational forms compete for consumers, managers, labor, and supplies of capital and other goods. Those that supply the goods demanded by customers at the lowest price win out. The dominance of the corporate form of organization in large-scale nonfinancial activities indicates that it is winning much of this competition.



Acquisition folklore

Takeovers can be carried out through mergers, tender offers, and proxy fights, or sometimes through elements of all three. A tender offer made directly to the stockholders to buy some or all of their shares for a specified price during a specified time period does not require the approval of the target company's management or board of directors. A merger, however, is negotiated with the company's management and, when approved by its board of directors, is submitted to the shareholders for approval. In a proxy contest the votes of the stockholders are solicited, generally for the election of a new slate of directors.

Takeovers frequently begin with what is called a "friendly" merger offer from the bidder to the target management and board. If management turns down the offer, the bidder can, and often does, take the offer directly to the shareholders in the form of a tender offer. At this point, target company managers usually oppose the offer by issuing press releases condemning it as outside the shareholders' best interest, by initiating court action, by requesting antitrust action against the bidder, by starting a countertakeover move for the bidder, and by other actions designed to make the target company a less desirable acquisition.

Target company management often casts about for a "white knight" – a friendly merger partner who will protect the "maiden" from the advances of the feared raider and, more important, who will pay a higher price. When the company doesn't find a white knight, and an unfriendly bidder takes it over, its leaders will likely look for new jobs. The takeover process penalizes incompetent or self-serving managers whose actions have lowered the market price of their corporation's stock. Although the process operates with a lag, the forces are strong and persistent. Of course – as a result of economies of scale or other efficiencies – some efficient managers lose their jobs after a takeover through no fault of their own.

This kind of romantic language has been used to offer comic relief, but it contributes to the atmosphere of folklore that surrounds a process fundamental to the corporate world. The resulting myths and misunderstandings distort the public's perception and render a meaningful dialogue impossible.

Folklore: Takeovers harm the shareholders of target companies.

Fact: The pejorative term *raider* used to label the bidding company in an unfriendly takeover suggests that the bidder will buy control of a company, pillage it, and leave the stockholders with only a crumbling shell.

Exhibit I Abnormal stock price increases from successful takeovers*

	Target companies	Bidding companies
Tender offers	30 %	4 %
Mergers	20 %	0 %
Proxy contests	8 %	N.A.†

*Adjusted to eliminate the effects of marketwide price changes
†Not applicable

More than a dozen studies have painstakingly gathered evidence on the stock price effect of successful takeovers (see *Exhibit I* for a summary of the results).* According to these studies, companies involved in takeovers experience abnormal increases in their stock prices for approximately one month surrounding the initial announcement of the takeover. (Abnormal stock price changes are stock price changes customarily adjusted by regression analysis to eliminate the effects of marketwide forces on all corporations.)† The exhibit shows that target company shareholders gain 30% from tender offers and 20% from mergers.

Because tender offers are often extended for less than 100% of the outstanding shares and because not all takeover announcements result in acquisitions, stock prices do not increase at the announcement of the offer by the full amount of the premium offered. Consequently, average target stockholder returns in takeovers are actually higher than the estimates in *Exhibit I* because the abnormal stock price changes it summarizes generally exclude the purchase premiums shareholders receive when they surrender their shares.

The shareholders of bidding companies, on the other hand, earn only about 4% from tender offers and nothing from mergers. If the much feared raiding has taken place, it seems to be of a peculiar, Robin Hood variety.

When an insurgent group, led by a dissatisfied manager or a large stockholder, attempts to gain controlling seats on the board of directors of a company (thereby taking over the company through an internal proxy fight), shareholders also gain. As *Exhibit I* shows, the stock prices of these companies gain 8% on average.

Because target companies are usually a lot smaller than the bidders, you cannot calculate total returns to both parties from the data in *Exhibit I*. An analysis of more than 180 tender-offer acquisitions, however, indicates statistically significant gains to target and acquiring company shareholders equal to an

average 8.4% of the total market value of the equity of both companies."

In sum, contrary to the argument that merger activity wastes resources without benefiting stockholders, stockholders earn substantial gains in successful takeovers. In the Texaco takeover of Getty, for example, Getty Oil shareholders realized abnormal stock price gains of $4.7 billion, or 78.6% of the total equity value, and Texaco shareholders, abnormal returns of $1.3 billion or 14.5%. Gains for both totaled $6 billion, 40% of the sum of their equity values. Gulf stockholders earned abnormal returns of $6.2 billion (79.9%) from the Socal takeover, and Socal stockholders earned $2.8 billion (22.6%). The total gains of $9 billion in this merger represent a 44.6% increase in the total equity values of both companies.

In light of these shareholder benefits, the cries to eliminate or restrain unfriendly takeovers seem peculiar (and in some cases self-serving). In a January 5, 1983 *Wall Street Journal* article, Peter Drucker called for such controls: "The question is no longer whether unfriendly takeovers will be curbed but only when and how." He went on to say:

"The recent shoot-out between Bendix and Martin Marietta has deeply disturbed even the staunchest laissez-faire advocates in the business community. And fear of the raider and his unfriendly takeover bid is increasingly distorting business judgment and decisions. In company after company the first question is no longer: Is this decision best for the business? But, will it encourage or discourage the raider?"

Such arguments may comfort concerned managers and board members who want protection from the discipline of competition in the market for managers. But they are based on false premises. The best way to discourage the competing manager (that's what *raider* means) is to run a company to maximize its value. "Will this decision help us obtain maximum market value?" is the only logically sensible interpretation of "What is best for the business?"

Folklore: Takeover expenditures are wasted.

Fact: Purchase prices in corporate takeovers represent the transfer of wealth from the stockholders of bidding companies to those of target organizations, not the consumption of wealth. In a takeover, the resources represented in the cash received by the target shareholders can still be used to build new plant and equipment or for R&D.

The only resources consumed are those used to arrange the transaction, such as the time and fees of managers, lawyers, economists, and financial consultants. These expenses are often large in dollar terms; the financial fees of the U.S. Steel/Marathon Oil merger were more than $27 million, and those received by four investment banking firms in the Getty takeover hit a record by exceeding $47 million. But they are a tiny fraction of the dollar value of the acquisition; total financial and legal fees usually amount to only about .7%. More significantly, they help shareholders achieve their much larger gains of 4% to 30%.

In fact, the stock price change is the best measure of the takeover's future impact on the organization. The vast scientific evidence on the theory of efficient markets indicates that, in the absence of inside information, a security's market price represents the best available estimate of its true value.[7] The evidence shows that market prices incorporate all current public information about future cash flows and the value of individual assets in an unbiased way. Stock prices change, of course, in response to new information about individual assets. Because market prices are efficient, however, the new information is equally likely to cause them to decrease or increase, after allowing for normal returns. Positive stock price changes, then, indicate a *rise* in the total profitability of the merged companies. Furthermore, because evidence indicates it does not come from the acquisition of market power, this increased profitability must come from the company's improved productivity.

Folklore: The huge bank credit lines used to carry out large takeovers siphon credit from the financial system and crowd out "legitimate" borrowing for productive investments.

Fact: First, the increases in shareholder wealth I've discussed indicate that takeover activities are productive investments; credit lines are not wasted. Second, companies that make acquisitions with stock or other securities, or with cash on hand or capital acquired from the sale of assets, do not use bank credit.

More important, even when companies accomplish takeovers with bank loans, they do not waste credit because most, if not all, of it is still available for real investment such as new plant and equipment. Let me illustrate the point by using a simple example.

When an acquiring company borrows from a bank for an acquisition, it receives the funds in the form of a credit to its bank account. When target company stockholders deposit receipts from the takeover in their accounts, the bank's total deposits remain unchanged because the acquirer's deposits are reduced by the same amount.

Now, however, the portfolios of the target company shareholders are unbalanced. In response, they can make new investments either directly or by purchasing newly issued shares, and if they do so the credit goes directly into productive real investments. If they take the opposite course of action and reduce their bank debt, the bank will have the same amount of loans and deposits as before the acquisition; total outstanding credit is unchanged and there is no waste.

Alternatively, target company shareholders can purchase securities from other investors, but the sellers then are in the same position as the target company shareholders after the acquisition.

If the recipients of the funds from the takeover don't make new investments or pay down debt, they must increase either their cash holdings or their consumption. If their wealth hasn't changed, they have no reason to change either their cash balances or their consumption, and, therefore, the proceeds will go to make new investments and/or reduce debt. If investor wealth increases, investors will increase their consumption and their cash balances. The value of the consumption and cash balance increases will only be a small fraction of the wealth increase (the capital gains, not the proceeds) from the takeover; the remainder will go for new investments and/or debt reduction. The increase in cash balances and consumption will be the same as that coming from increases in wealth generated by any other cause. Thus, takeovers waste no more credit than any other productive investment.

Folklore: By merging competitors, takeovers create a monopoly that will raise product prices, produce less, and thereby harm consumers.

Fact: The evidence from four studies of the issue indicates that takeover gains come not from the merger's creation of monopoly market power but from its productive economies and synergy.

If the gains did come from the creation of companies with monopolistic powers, industry competitors would benefit, in turn, from the higher prices and would enjoy significant increases in profits and stock prices. Furthermore, the stock prices of rivals would fall if the FTC or the Antitrust Division of the Justice Department cancelled or challenged the merger.

The evidence indicates, however, that competitors gain when two other companies in the same industry merge. But these gains are not related to the creation of monopolistic power or industry concentration. Moreover, the stock prices of competitors do not fall on announcement of antitrust prosecution or cancellation of the acquisition. This evidence supports the hypothesis that takeover gains stem from real economies in production and distribution realized through the takeover and that it signals the availability of similar gains for rival companies.*

In fact, the evidence raises serious doubts about the wisdom of FTC or Justice Department policies concerning mergers. The cancellation of an acquisition erases virtually all the stock price increases occurring on its announcement – with no apparent offsetting benefits to anyone.*

Folklore: Consolidating facilities after a takeover leads to plant closings, layoffs, and employee dismissals – all at great social cost.

Fact: No evidence with which I am familiar indicates that takeovers produce more plant closings, layoffs, and dismissals than would otherwise have occurred.

This charge raises a serious question, however, about the proper criteria for evaluation of the social desirability of takeovers. The standard efficiency yardstick measures increases in the aggregate real standard of living. By these criteria the wealth gains from takeovers (and their associated effects) are good as long as they do not come from the creation of monopolistic market power. Therefore, even if takeovers lead to plant closings, layoffs, and dismissals, their prohibition or limitation would generate real social costs and reduce aggregate human welfare because of the loss of potential operating economies.

Some observers may not agree that the standard efficiency criterion is the best measure of social desirability. But the adoption of any other criterion threatens to paralyze innovation. For example, innovations that increase standards of living in the long run initially produce changes that reduce the welfare of some individuals, at least in the short run. The development of efficient truck and air transport harmed the railroads and their workers; the rise of television hurt the radio industry. New and more efficient production, distribution, or organizational technology often imposes similar short-term costs.

The adoption of new technologies following takeovers enhances the overall real standard of living but reduces the wealth of those individuals with large investments in older technologies. Not surprisingly, such individuals and companies, their unions, communities, and political representatives will lobby to limit or prohibit takeovers that might result in new technologies. When successful, such politics reduce the nation's standard of living and its standing in international competition.

Folklore: Managers act in their own interests and are in reality unanswerable to shareholders.

Fact: Because executive compensation is related to company size, critics charge that a top officer's desire for wealth and an empire drives merger activity while the stockholders pay the bill. But as *Exhibit I* shows, there is no systematic evidence that bidding company managers are harming shareholders to build empires. Instead, the evidence is consistent with the synergy theory of takeovers. This theory argues that the stock price increases for target companies come from the increase in value obtained by consolidating or altering control of the assets of the companies involved, perhaps because of cost savings from economies of scale or from a highly complementary combination of employees and assets in production and distribution.

The evidence shows that target companies get a large share of the gains; indeed, the gains in mergers go to the target companies while virtually none accrue to bidding companies on the average. Bidding wars such as the DuPont-Seagram-Mobil competition for control of Conoco push up the gain for target companies.

The zero returns to bidders in mergers noted in *Exhibit 1* are puzzling. For several reasons, however, this particular estimate has more uncertainty built into it and is probably biased downward. My own assessment is that the returns to bidding companies in mergers are closer to the 4% shown for bidders in tender offers. An examination of the total dollar gains to both bidding and target company shareholders shows that both get about the same amount of dollars but not of percentage gains. The disparity results because bidding companies are generally larger than target companies and the same dollar gains translate into different percentage gains. Because the stock prices of larger companies vary more widely relative to gains in an acquisition than do the stock prices of target companies, their returns cannot be estimated as precisely.

Furthermore, bidders often engage in a prolonged acquisition program. The benefits for target companies from a particular merger occur around the time of the takeover announcement and therefore can be more easily estimated than the bidders' benefits, which may be spread out over several acquisitions.

Often the stock price of a company that seeks several acquisitions reflects the projected benefits of future deals at an early date.[7] When a particular acquisition is announced, the bidder's stock price will change only to the extent that there is a difference between the actual and the previously expected profitability of the merger and on average this will be zero in an efficient market. And because mergers involve negotiations that do not occur in tender offers, more information about the intentions of bidders will leak than will information about the identity of the target; the effect on the bidder's price will therefore be spread out over time.

The record of several large takeovers shows mixed evidence on the returns to acquiring shareholders. In the $13.2 billion takeover of Gulf, Socal shareholders earned $2.77 billion (22.6%) after adjustment for the effects of marketwide price changes (from January 23, 1984 to May 3, 1984). Similarly, in the $10.1 billion takeover of Getty Oil, Texaco shareholders earned $1.3 billion (14.5%, from December 13, 1983 to February 7, 1984). In contrast, Allied shareholders lost $100 million (−8.6%) in the acquisition of Bendix; DuPont lost $800 million (−10.0%) in the takeover of Conoco, while Conoco shareholders realized a gain of 71%, or about $3.2 billion.[8]

On the other hand, Occidental Petroleum shareholders did *not* lose in Occidental's takeover of Cities Service, whose shareholders gained about $350 million (12.5%).[9] Mesa Petroleum initiated the Cities Service war with a bid of $45 per share. Cities Service countered with a bid for Mesa Petroleum. Gulf Oil then announced completion of negotiations to merge with Cities Service for $63 per share. Cities Service stock immediately gained over 43%, or $1.25 billion. In contrast, the Gulf stock price fell over 14%, or slightly over $900 million. The $350 million difference between the gain to Cities Service shareholders and the loss to Gulf shareholders measures the market's estimate of the net increase in value from the merger.

Citing antitrust difficulties with the FTC, Gulf cancelled its acquisition of Cities Service seven weeks later. Cities Service countered with a breach of contract suit against Gulf for $3 billion. All the earlier gains in the price of Cities Service stock were eliminated, but only one-third of the Gulf loss was recovered—perhaps because the market forecast that legal action might hold Gulf liable for part of the premium offered to Cities Service shareholders or that Gulf would make more overpriced takeover attempts. Within four weeks of the Gulf cancellation, Cities Service merged with Occidental for a $350 million premium—an amount identical to the estimated value of the net merger gains from the aborted combination of Cities Service and Gulf.

A good way for a company to become a takeover target is to make a series of acquisitions that reduce value but allow the value to be recovered through divestiture. A bidder that realizes it can make money by selling off the pieces at a profit will likely seize the initiative. Victor Posner's attack on Marley Company in 1981 is an extreme example. Marley, which manufactured water-cooling towers and heat exchangers, took control of Wylain, a manufacturer of air conditioning, heating, and pumping systems, for an 87% premium over Wylain's previous market value. Marley's stock price fell 21%. Posner bought 11.2% of Marley during the first six months of 1980. Unable to find a white knight, Marley sold its assets, dissolved, and distributed the proceeds in June 1981. Posner received $21.9 million for his investment of $12.5 million in Marley.[10]

Manager-shareholder conflicts

The interests of managers and shareholders conflict on many, but certainly not all, issues. The divergence intensifies if the company becomes the target of an unfriendly takeover. *Exhibit 1* indicates that target shareholders benefit when the bidders offer sub-

Exhibit II Abnormal stock price changes from unsuccessful bids*

	Target companies	Bidding companies
Tender offers	3%	1%
Mergers	3%	5%
Proxy contests	8%	N.A.†

*Adjusted to eliminate the effects of market-wide price changes for appropriate

stantial premiums over current market value. During a takeover, top managers of target companies can lose both their jobs and the value of their talents, knowledge, and income that are particular to the organization. Threatened with these losses, such officers may try to reduce the probability of a successful unfriendly takeover and benefit themselves at the expense of shareholders.

Management struggles

The attempt by Carter Hawley Hale to acquire Marshall Field is an interesting example of a management struggle to retain control. Marshall Field, a high-quality department and specialty store chain, enjoyed less growth than other retailers but consistently rejected merger bids. In early 1978, Carter Hawley Hale, another retailer, offered $42 per share for Marshall Field stock, which was selling for less than $20. Resisting, Marshall Field filed a lawsuit that argued the acquisition would violate securities and antitrust laws. It informed shareholders that the asking price was inadequate and made several defensive acquisitions that aggravated potential antitrust problems and made it less attractive to Carter Hawley. Marshall Field's board authorized top officials to take "such action as they deemed necessary" to defeat the offer. After Carter Hawley withdrew the offer, Marshall Field's stock fell back to $20 per share.

In April 1984, another retailer, The Limited, tried to take over Carter Hawley Hale, whose stock then experienced abnormal gains of 49% in the ensuing conflict. Carter Hawley filed suit against The Limited, claiming securities law violations and antitrust problems, and gave up 33% of its voting rights through the sale of $300 million of convertible preferred stock to General Cinema Corporation. Carter Hawley then gave General Cinema a six-month option to buy the Waldenbook chain, one of its most profitable subsidiaries, and repurchased 51% of its own shares. As a result The Limited withdrew its offer in May and Carter Hawley stockholders lost $363 million – the entire 49% abnormal stock price gain.

Both of these cases show what happens to stock prices when acquisition bids fail. *Exhibit II* summarizes the general evidence obtained from ten studies on stock price behavior during unsuccessful takeover attempts. The average abnormal stock price changes surrounding unsuccessful takeover bids are uniformly small and negative, ranging from −1% to −5%. The exception is the 8% positive return to shareholders of companies subjected to unsuccessful proxy contests. It is interesting that a proxy contest causes an abnormal stock price gain even when the challengers fail, perhaps because the contest threat motivates incumbent managers to change their strategies.

The uncertainty of the estimates, however, means that only the −5% return for unsuccessful bidders is statistically significantly different from zero. The other negative returns can arise by chance if the true returns from such unsuccessful offers are actually zero. In conclusion, the Marshall Field experience that target company shareholders essentially lose all the offered premiums when an acquisition bid fails, fits the general evidence.

Exhibit II, however, simplifies the story. Sometimes stockholders benefit greatly from opposition to takeover bids.

Uncoordinated, independent decisions by individual shareholders regarding the acceptance or rejection of a tender offer can cause most of the takeover gains to go to bidding company stockholders.[4] If target managers act as the agents for all target shareholders in negotiating with the bidder for a higher price, however, this "free rider" problem can be alleviated.

Empirical evidence also indicates that some managerial opposition benefits target shareholders. For example, on the failure of a tender offer, target stock prices do not on average immediately lose the 30% average increase in price they earned when the offer was made. In fact, they generally stay up, apparently in anticipation of future bids. And target companies that receive at least one more bid in the two years following the failure of a tender offer on average realize another 20% increase in price. Those targets that do not receive another bid, however, lose the entire initial price increase.[5] Apparently, a little opposition in a merger battle is good, but too much can be disastrous if it prohibits takeover of the company.

The corporate charter

Corporate charters specify governance rules and establish conditions for mergers, such as the percentage of stockholders who must approve a takeover. Since constraints on permissible charter rules dif-

fer from state to state, changing the state of incorporation will affect the contractual arrangement among shareholders and the probability that a company will be a takeover target. It is alleged that some states desiring to increase their corporate charter revenues make their statutes appealing to corporate management. Allegedly, in doing so they provide management with great freedom from stockholder control and therefore provide little shareholder protection. Delaware, for example, has few constraints in its rules on corporate charters and hence provides much contractual freedom for shareholders. William L. Cary, former chairman of the Securities and Exchange Commission, has criticized Delaware and argued that the state is leading a "movement towards the least common denominator" and "winning a race for the bottom."[76]

But a study of 140 companies switching their state of incorporation reveals no evidence of stock price declines at the time of the change, even though most switched to Delaware.[77] In fact, small abnormal price increases are usually associated with the switch. This evidence is inconsistent with the notion that such charter changes lead to managerial exploitation of shareholders.

Without switching their state of incorporation, companies can amend corporate charters to toughen the conditions for the approval by shareholders of mergers. Such antitakeover amendments may require a "super majority" for approval or for the staggered election of board members and can thus lower the probability that the company will be taken over and thereby reduce shareholder wealth. On the other hand, the amendments can also benefit shareholders by increasing the plurality required for takeover approval and thus enable management to better represent their common interests in the merger negotiations.

Two studies of adoption of antitakeover amendments in samples of 100 and 388 companies reveal no negative impact on shareholder wealth.[78] One exception may arise if the super-majority provisions grant effective power to block mergers to a manager-stockholder. The market value of R. P. Scherer, for example, fell 33.8% when shareholders adopted an 80% super-majority merger approval provision. Because the wife of Scherer's CEO owned 21.1% of the stock, she then had the power to block a proposed takeover by FMC. In fact, FMC withdrew its offer after Scherer stockholders approved the 80% majority provision and the price of Scherer stock plummeted.

Repurchase standstill agreements

Currently available evidence suggests that management's opposition to takeovers reduces shareholder wealth only when it eliminates potential takeover bids. In a privately negotiated or targeted repurchase, for example, a company buys a block of its common stock from a holder at a premium over market price – often to induce the holder, usually an active or a potential bidder, to cease takeover activity. Such repurchases, pejoratively labeled "greenmail" in the press, generate statistically significant abnormal stock price declines for shareholders of the repurchasing company and significantly positive returns for the sellers.[79] These stock price declines contrast sharply with the statistically significant abnormal stock price increases associated with *nontargeted* stock repurchases found in six studies.[80]

The managers of target companies also may obtain standstill agreements, in which one company agrees to limit its holdings in another. Announcements of such agreements are associated with statistically significant abnormal stock price declines for target companies. Because these agreements almost always lead to the termination of an acquisition attempt, the negative returns seem to represent the merger gains lost by shareholders.

Again, however, the issue is not clear-cut because closer examination of the evidence indicates that these takeover forays by competing managers benefit target shareholders. Within ten days of an acquisition of 5% or more of a company's shares, the SEC requires the filing of information giving the identity of the purchaser, purpose of acquisition, and size of the holding. The significantly positive increase in stock price that occurs with the initial purchase announcement indicates that potential dissident activity is expected to benefit shareholders even given the chance that the venture will end in a targeted repurchase. Moreover, this is confirmed by the fact that on average during the period from the SEC filing through the targeted repurchase of the shares, target company shareholders earn statistically significant positive abnormal returns.[81]

Thus, when you look at the whole process, repurchase agreements are clearly not "raiding" or "looting" but are profitable for the target shareholders – although not as profitable as a takeover. The stock price decline at repurchase seems due to the repurchase premium that is effectively paid by the nonselling shareholders of the target firm and to the unraveling of takeover expectations with consequent loss of the anticipated takeover premium.

Because, on average, target shareholders lose the anticipated takeover premiums shown in

Exhibit I when a merger or takeover fails for any reason, we cannot easily tell whether they were hurt by a repurchase. If the takeover would have failed anyway and if the target company's stock price would have fallen even more without the repurchase, then the repurchase benefited target company shareholders. Such additional price declines might be caused, for example, by the costs of dealing with a disgruntled minority shareholder.

Although the issue requires further study, current evidence implies that prohibition of targeted large block repurchases advocated by some may hurt target shareholders. Moreover, since shareholders can amend corporate charters to restrict targeted repurchases, there is little justification for regulatory interference by the state in the private contractual arrangements among shareholders. Such repurchase restrictions might well restrict the vast majority of stock repurchases that clearly benefit shareholders. In addition, by reducing the profitability of failed takeovers, such restrictions would strengthen the position of entrenched managers by reducing the frequency of takeover bids. Doing so would deprive shareholders of some of the stock price premiums associated with successful mergers.

Going private

The phrase *going private* means that publicly owned stock is replaced with full equity ownership by an incumbent management group and that the stock is delisted. On occasion, when going private is a leveraged buy-out, management shares the equity with private investors. Some believe that incumbent managers as buyers are exploiting outside shareholders as sellers in these minority freeze-outs.

Advocating restrictions on going-private transactions, in 1974 Securities and Exchange Commissioner A. A. Sommer, Jr. argued:

"What is happening is, in my estimation, serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing, and a course that inevitably is going to make the individual shareholder even more hostile to American corporate mores and the securities markets than he already is."[11]

Study of stockholder returns in 72 going-private transactions, however, reveals that the average transaction offers a premium 56% over market price and that abnormal stock price increases on announcement of the offer average 30%. The gains apparently arise from savings of registration and other public ownership expenses, improved incentives for decision makers under private ownership, and increased interest and depreciation tax shields. Outside shareholders are not harmed in going-private transactions.[12]

Golden parachutes

Some companies provide compensation in employment contracts for top-level managers in the event that a takeover occurs – that is, golden parachutes. Allied agreed, for example, to make up the difference for five years between Bendix CEO William Agee's salary in subsequent employment and his former annual $825,000 salary in the event of a change in control at Bendix. Much confusion exists about the propriety and desirability of golden parachutes, even among senior executives.

But the detractors fail to understand that the parachutes protect stockholders as well as managers. Think about the problem in the following way: top-level managers and the board of directors act as stockholders' agents in deals involving hundreds of millions of dollars. If the alternative providing the highest value to stockholders is sale to another company and the retirement of the current management team, stockholders do not want the managers to block a bid in fear of losing their own jobs. Stockholders may be asking managers to sacrifice position and wealth to negotiate the best deal for them.

Golden parachutes are clearly desirable when they protect stockholders' interests. Like anything else, however, they may be abused. For example, a stockholder doesn't want to pay managers so much for selling the company that they hurry to sell at a low price to the first bidder. But that is a problem with the details of the parachute's contractual provisions and not with the existence of the parachute itself. An analysis of 90 companies shows that adoption of golden parachutes on average has no negative effect on stock prices and provides some evidence of positive effects.[13]

The thing that puzzles me about most golden parachute contracts is that they pay off only when the manager leaves his job and thus create an unnecessary conflict of interest between shareholders and executives. Current shareholders and the acquiring company will want to retain the services of a manager who has valuable knowledge and skills. But the officer can collect the golden parachute premium only by leaving; the contract rewards him or her for taking an action that may well hurt the business. As the bidder assimilates the knowledge that turnover among valuable top-level managers after the acquisition is highly likely, it will reduce its takeover bid. A company can eliminate this problem by making the award conditional on transfer of control and not on the manager's exit from the company.

Selling the 'crown jewels'

Another often criticized defensive tactic is the sale of a major division by a company faced with a takeover threat. Some observers claim that such sales prove that managers will do anything to preserve their tenure, even to the extent of crippling or eliminating major parts of the business that appear attractive to outside bidders. Such actions have been labeled a "scorched earth policy."

Studies of the effects of corporate spin-offs, however, indicate they generate significantly positive abnormal returns.[14] Moreover, when target managers find a white knight to pay more for the entire company than the initial, hostile bidder, shareholders clearly benefit.

In the same way, when an acquirer is interested mainly in a division rather than the whole company, shareholders benefit when target management auctions off the unit at a higher price. Brunswick's sale of its Sherwood Medical Industries division to American Home Products shows how the sale of a crown jewel can benefit shareholders. Whittaker Corporation made a hostile takeover bid for Brunswick in early 1982. In defense, Brunswick sold a key division, Sherwood Medical, to American Home Products through a negotiated tender offer for 64% of Brunswick's shares. American Home Products then exchanged these shares with Brunswick for Sherwood's stock. Because its main interest lay in acquiring Sherwood, Whittaker withdrew its offer.[15]

The value of the Whittaker offer to Brunswick shareholders ranged from $605 million to $618 million, depending on the value assigned to the convertible debentures that were part of the offer. The total value to Brunswick shareholders of the management strategy, selling off the Sherwood division, was $620 million. Moreover, because of the structure of the transaction, the cash proceeds went directly to the Brunswick shareholders through the negotiated tender offer. The $620 million value represents a gain of $205 million (49%) on the total equity value of Brunswick prior to the initial Whittaker offer. The Brunswick shareholders were $2 million to $15 million better off with the management strategy, hardly evidence of a scorched-earth policy.

Takeover artists

Recently, criticism has been directed at corporate takeover specialists who are said to take advantage of a company's vulnerability in the market and thus ultimately harm shareholders. While acting in their own interests, however, these specialists also act as agents for shareholders of companies with entrenched managers. Returning to the Marshall Field story, for example, Carl Icahn launched a systematic campaign to acquire the chain after it had avoided takeover. When it looked as if he would achieve the goal, Marshall Field initiated a corporate auction and merged with BATUS (British American Tobacco Company, U.S.) for $30 per share in 1982. After adjustment for inflation, that price was slightly less than the $20 price of Field's stock in 1977, when it defeated Carter Hawley's $42 offer.

Takeover specialists like Icahn risk their own fortunes to dislodge current managers and reap part of the value increases available from redeploying the assets or improving the management. Evidence from a study of 100 such instances indicates that when such specialists announce the purchase of 5% or more of a company's shares, the stockholders of that company on average earn significantly positive abnormal returns of about 6%.[16]

The effectiveness of the market

The corporation has contributed much to the enhancement of society's living standards. Yet the details of how and why this complex institution functions and survives are poorly understood, due in part to the complexity of the issues involved and in part to the political controversy that historically surrounds it. Much of this controversy reflects the actions of individuals and groups that wish to use the corporation's assets for their own purposes, without purchasing them.

One source of the controversy comes from the separation between managers and shareholders – a separation necessary to realize the large efficiencies in risk bearing that are the corporation's comparative advantage. The process by which internal control mechanisms work so that professional managers act in the shareholders' interest is subtle and difficult to observe. When internal control mechanisms are working well, the board of directors will replace top-level managers whose talents are no longer the best ones available for the job.[17]

When these mechanisms break down, however, stockholders receive some protection from the takeover market, where alternative management teams compete for the rights to manage the corporation's assets. This competition can take the form of mergers, tender offers, or proxy fights. Other organizational forms such as nonprofits, partnerships, or mutual

insurance companies and savings banks do not benefit from the same kind of external market.

The takeover market also provides a unique, powerful, and impersonal mechanism to accomplish the major restructuring and redeployment of assets continually required by changes in technology and consumer preferences. Recent changes occurring in the oil industry provide a good example.

Scientific evidence indicates that activities in the market for corporate control almost uniformly increase efficiency and shareholders' wealth. Yet there is an almost continuous flow of unfavorable publicity and calls for regulation and restriction of unfriendly takeovers. Many of these appeals arise from managers who want protection from competition for their jobs and others who desire more controls on corporations. The result, in the long run, may be a further weakening of the corporation as an organizational form and a reduction in human welfare.

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Senator D'AMATO. Thank you very much, Mr. Pickens.
Sir James Goldsmith.

STATEMENT OF SIR JAMES GOLDSMITH, CHAIRMAN, GENERAL ORIENTAL INVESTMENTS, LTD.

Sir JAMES GOLDSMITH. Mr. Chairman and members of the subcommittee, as a foreigner, based in Europe, I appreciate particularly the opportunity of testifying here today.

Senator D'AMATO. We're pleased, Sir James, that you took from your time to be here with us. This should be an interesting panel when we get to asking the questions.

[The complete prepared statement follows:]

STATEMENT OF

SIR JAMES GOLDSMITH

CHAIRMAN

GENERAL ORIENTAL INVESTMENTS LIMITED

Mr. Chairman and Members of the Subcommittee. As a foreigner, based in Europe, I appreciate the opportunity of testifying here today. For many years, I have been a substantial participant in business throughout Europe and more recently have become an active investor in the United States. Therefore, I have witnessed the decline of Europe and the contemporaneous resurgence of the United States and this gives me a particular perspective from which to testify.

The dominant ideology of Europe has fluctuated between Socialism and State Corporatism. These have been the root causes of the European economic disease. State Corporatism is based on the conviction that the activities of a nation can best be managed through the triangular cooperation of the state, business and trade unions. For example, corporatists believe that salaries and prices in whole industries and nationwide can be settled annually by negotiations between employer associations and trade unions, presided over by government. They do not believe in the mechanisms of the marketplace which they feel are brutal and destablizing.

At the base of the pyramid or triangle is big business and big unions. At the peak is government. As a result, a mutuality of interest, indeed a certain com-

plicity, has evolved between big corporate management, trade union leaders and government bureaucrats. They need each other. Small and medium sized business has no natural place in such a system. In Great Britain, for example, an official inquiry on small firms has revealed that small businesses accounted for a smaller proportion of output and employment than in any other industrialized country.

Here in the USA, you have followed a very different route, a route which has led to a new industrial revolution. Some call it a techno-scientific revolution. Some call it an entrepreneurial revolution. Since 1965, while Europe has been losing jobs at a truly alarming rate, your revolution has created 35 million new jobs. The new jobs are coming from small and medium sized businesses usually run by innovators and entrepreneurs whereas large and mature industries are shedding employment each year. This shift is fundamental because, contrary to Europe, it reduces the role and power of the mega-corporations and the trade unions. It creates a polyculture of businesses all competing one against the other. It creates a truly competitive economy and in a truly competitive economy either you do it right or you get eliminated. Mega-companies either get it right or they

get taken over. Trade unions have to agree to competitive practices or unionized companies perish and trade union membership is correspondingly reduced.

During the past few months in the United States, there has been a national debate about hostile takeovers. It seems to me that this debate is really about your new entrepreneurial revolution and the freedoms that have engendered it. The question really being asked is whether or not large corporations should be treated like institutions and should be granted special protection from the marketplace.

Who would have believed a few years ago that conglomerates, created at the time by freewheeling entrepreneurs, today are described by some as sacrosanct institutions which should be protected from the marketplace by special legislation. All that has changed in many of these companies is that the flame of the founder has been replaced by the complacency of the bureaucrat. And because the members of such bureaucracies control the disposition of vast amounts of other people's money and the power and patronage that accompany it, they feel they are part of the establishment and therefore deserve special privileges.

Mr. Chairman, I speak on this subject with some emotion because I have seen it all before. In France, the combined results of the largest forty corporations which include the leaders in every field of industrial and commercial endeavor, was a loss of over two billion dollars. These are the corporations which were treated like institutions and which were protected from change by government action. Any takeover attempt on these corporations would be met with howls of anguish and indignation. Their management would run to the Government to plead for special protection, and in most cases, would receive it. Among these companies are a small minority which are excellent. But as for the others, the best thing that could happen to France and to those directly or indirectly affected, would be that they should be taken over and that their constituent parts be liberated from the dead hands of establishment bureaucrats. I believe that this is another way of describing what some witnesses who have appeared before you have called "bust-up, hostile takeovers."

For many years conventional wisdom has been that bigness, in itself, is somehow good. It allowed for magnificent investment projects without recourse to leverage; it allowed companies to diversify and this was

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supposed to protect them against cyclical swings, and as far as management was concerned, bigness put their companies beyond the threat of hostile takeovers.

That thinking has now been challenged. Big investment, in itself, is not necessarily a virtue. Recently in Britain, Mrs. Thatcher said that when she first became a government minister, the conversations were about how many billions were needed to expand national corporations like British Steel. A few years later, the conversations were about how many billions were needed to shrink the same corporations.

Diversification can sometimes protect groups against such cyclical swings but also many companies have proved unable to handle the diversity of problems and opportunities which arise in multi-industry corporations.

Even the effects of leverage have been reconsidered. For example, in Japan the debt-to-equity ratio in the leading 350 companies is three to four times greater than that for the average of the Forbes 1,000 U.S. companies.

Finally, the financial markets now are big enough to finance a challenge even to huge corporations. The market will put up the money if it believes that the fundamental value of a company is much greater than its

market value and that the fundamental values can be liberated.

Some corporate managements react to this situation by creating a panoply of artificial devices to entrench themselves. They also appear before your committee to plead for special protection. Others take the positive steps which are needed to deploy their assets properly. ARCO, Litton, Gulf and Western are good recent examples of companies that are doing the right things. Free market forces either force management to get to work or alternatively allow new owners and new management to take over. Artificial devices which inhibit such changes do no more than protect the unsatisfactory. They lead to ossification and decline.

Mr. Chairman, I will not review the particularities of abuses and counter-abuses which automatically occur during takeover contests. You have already heard learned testimony about all of this.

I would only like to make one obvious point. Corporations are owned by their shareholders. Management is employed by shareholders to look after shareholder interests. Devices like poison pills, paying greenmail, scorched earth, defensive acquisitions, super majority voting, staggered boards, etc..., should all be subject

to a prior and free vote by shareholders and should not be imposed unilaterally by management as a method of entrenchment. When management acts unilaterally, without consulting shareholders, it is seeking protection not for their shareholders but from their shareholders. Often management will have a good case to make. If so, it should make it and convince its constituents.

My only qualification to this is that the effects of such special resolutions, even if approved by shareholders, should not become permanent. Management should not be entrenched forever. Life tenure is seldom healthy.

It must be remembered that almost always, directors are not chosen and elected by shareholders. Normally, shareholders are asked to vote on a list of directors proposed by management. There are no primaries and only very rarely, and at a great cost, is an alternative list of candidates proposed to shareholders and this is within the context of proxy fights. So in effect, directors are co-opted by their future colleagues and shareholders do no more than ratify the proposals.

If, during a period of relative calm and prosperity, directors can obtain a vote from shareholders on the permanent application of some of the entrenchment

devices that I mentioned earlier, then in effect, they and their co-opted successors are there for life -- whether or not subsequently that management is successful.

That is why I would strongly recommend that although management entrenchment and anti-takeover devices are legitimate when approved by shareholders, nonetheless they should be the subject of a regular vote and therefore, should be submitted annually to shareholder consideration. This would avoid life tenure of corporate management.

Shareholders on the other hand would be wise to eliminate conflicts of interest with management. Management sometimes is tempted by size, shareholders want value. Management is fearful of takeovers because of the inevitable uncertainties of change after many years of loyal service to their company. Shareholders should align the interests of management with their own by substantial incentive schemes and fair termination agreements, sometimes called "golden parachutes."

Mr. Chairman, your new industrial revolution is deep and vigorous. It is based on freedom. My most fervent hope is that one day my fellow Europeans will learn that freedom works and I also hope that Americans will never forget it.

Senator D'AMATO. Thank you very much, Sir James.

Let me make two observations if I might and then I'm going to ask my good friend and colleague, Senator Hecht, if he would chair the hearing. I have a meeting with the Attorney General.

It seems to me that you have a particular position in this whole issue of mergers, acquisitions, utilization of different techniques of financing corporate takeovers and acquisitions. If you are opposed to it, you use the word "junk bonds," and of course it's become a term of art which is referred to in all the media as junk bonds. If we take a different position, one which is in favor of the utilization of these instruments, we call them high yield.

So we can get a person's position pretty quickly by that term of art and whether they express it as junk or high yield.

I'm not suggesting one and I'm not going to send any great signals out, but I don't think that the term "junk bond" in the pejorative aptly fits the situation and that we have been doing some studying and the fact of the matter is that there have been many, many millions of jobs generated by use of high yield bonds and I'm not going to suggest to you that there may not be some abuses in the corporate takeover arena because I think there have been. But to simply pillory and to deprive it and to say that they have no place in our society is to overreact. You don't throw out the baby with the bath water because there is a need for certain requirements and I'm not directing that just to Mr. Hartley. I'm just saying to you that this is the fourth hearing we've had now and I have seen this.

Second, I might ask Sir James one question. You have listed an entire area of concern with respect to the defensive tactics that have been utilized by corporate management, but yet you fail to come forward with any suggestions that might improve the situation and address some of the inequities, and I'm certain that you have heard them.

So let me put one to you. Do you believe that when the offer is made that there should be more than just a commitment to make one's best effort to obtain the necessary financing?

Sir JAMES GOLDSMITH. Mr. Chairman, I have specific experience with this.

Senator D'AMATO. I know that.

TENDER OFFER TO CROWN ZELLERBACH

Sir JAMES GOLDSMITH. In that in the last few months I made a tender offer. A company of which I'm chairman—a partnership, to be exact—made an offer to acquire all the shares of a company called Crown Zellerbach and that offer was subject to financing. In fact, we did immediately afterwards tie down a banking commitment of $850 million on which we paid commitment fees. But when we made the offer it was subject to financing. Why was it subject to financing?

Crown Zellerbach had created and distributed a poison pill which made the offer irrelevant unless they were willing to withdraw that poison pill. So would you consider it reasonable, Mr. Chairman, that we should spend many, many millions of dollars in firm commitments for the $1.5 billion bid that we made when the possi-

bility of that bid going ahead was entirely and unilaterally in the hands not of the owners of the company, the shareholders, but in the hands of a defensive board who had issued unilaterally that poison pill?

So what did we do? We said, we will make an offer subject to the pill being withdrawn and we didn't want it to be just subject to financing. That is why we actually went out and got a $850 million commitment from the banks which we paid for, but that payment was more for cultural reasons than financial reasons. It was because of the sort of criticism implicit not from you, Mr. Chairman, but in the question being asked by some people. But I felt it entirely wrong that we should go out and pay those fees for commitments when the bid was a theoretical bid unless the poison pill had been withdrawn. That could only be withdrawn by the board, not by the shareholders who are the owners of the company.

Senator D'AMATO. Senator Hecht.

Senator HECHT. Mr. Hartley, you have a timeframe. What time do you have to get out of here?

Mr. HARTLEY. Ten minutes.

Senator HECHT. I'll pass then. Senator Proxmire.

Senator PROXMIRE. Well, if Mr. Hartley has to leave in 10 minutes, I have questions for others, so if anyone has questions for Mr. Hartley——

Senator HECHT. Do you have any questions for Mr. Hartley?

Senator PROXMIRE. Well, let me ask one question of Mr. Pickens and I'll ask Mr. Hartley to comment on it if he has to leave that quickly. I have a number of questions.

Mr. Pickens, first if you had gained control of Unocal, what would you have done to improve the management of the company that Mr. Hartley was not doing?

Mr. PICKENS. Well, I would just refer back to our record at Mesa Petroleum where we started with $2,500 in 1956 and the company had a balance sheet of less than $2 million of assets in 1964 when we went public and in 1985 we have a balance sheet of $4 billion in assets. The record is excellent.

Mr. Hartley likes to tell people if they had bought Unocal stock in 1960 and spent $10,000 it would be worth $100,000 today. I can give you 4 years because we didn't go public until 1964, and if you bought 10,000 dollars' worth of Mesa stock in 1964 it would be worth $300,000 today.

So when you say specifically what I would do, I don't think that I'm prepared at this point to say whether I would expand divisions or reduce divisions or whatever else, but our offer for Unocal was $54 a share if you recall. The combined blended value of the stock today is $44. So the company today has lost their stockholders from our offer almost $2 billion in just a matter of about 3 or 4 weeks. So had we taken over the company at $54 a share, we said we would not reduce personnel; we would not eliminate divisions; and remember again, if we bought it for $54 we would have owned the company at that point and it would have been a part of Mesa Petroleum. So some people would want to know what the stock would sell for if Mesa had bought it. There wouldn't be any stock. We would have owned Unocal at that point.

What would I do better than Mr. Hartley? I would say just look at the prior record and compare the records. By the way—a good point—if you look at 1984 and compare the two companies' return on common equity in 1984: From Unocal was 13 percent. Mesa was 15 percent, No. 1 in the industry category. Finding costs in 1984 per barrel with Unocal were $10.30 and for Mesa were $10.90. We of course didn't have the expenditure of the offshore development which has never gone on production. Shareholder equity increase in 1984 was Unocal 10 percent and Mesa 48 percent.

Senator PROXMIRE. Mr. Hartley, would you respond?

Mr. HARTLEY. Well, Mr. Chairman, numbers are marvelous things. Contrary to what Mr. Goldsmith said and some things Mr. Pickens has said, large as our company is, about $11 billion in sales, our company has continued to grow and hasn't grown by becoming a conglomerate consisting of everything from Swiss cheese to doughnuts. It's continued to grow as a result of commitment to spending money with an organized force of scientists and technologists to create new knowledge, new knowledge by which new investments can be made and new payrolls can be started, all in the field of resource development and in the production of products from that resource development.

This week we just finished putting on line a new needle coking plant which is going to make super coke for the new restructured steel industry which no longer in many respects used blast furnaces but uses electric anode materials, direct melting, and we will be providing this new coke for our country and replace imports with higher quality than I think the country has seen before.

I think our position regarding new energy forms which the generation of geothermal steam is probably the best example, brought about by the willingness to take risks and to get new knowledge—right now today, sir, we are the largest geothermal energy producer in the world, both here in the United States and in the Philippines, and soon to be in Indonesia where we are trying to help the developing countries on a participating venture with their citizens at no expense to the United States taxpayers.

As a result of all of this, we are now supplying the entire city of San Francisco and Oakland with electric power and it's another tens of thousands of barrels of oil per day that we no longer have to import from Saudi Arabia or other foreign countries.

CURRENT STATE OF UNOCAL

Senator PROXMIRE. Let me just ask you one other question, Mr. Hartley. How would you characterize the current state of Unocal after your takeover battle with Mr. Pickens? Has Unocal been hurt by that battle? Is it weaker or stronger?

Mr. HARTLEY. Senator Proxmire, the whole game here—if I really tell you what I think, I would just say that this country has gone insane. We had a well-run company. I would challenge anyone to challenge the quality of our management relative to the four internationals operating in our country. All that's happened here, sir, is that we have removed from equity on our books at a premium $4 billion and passed it out to our shareholders and we either had to do it within the political/economic/legislative climate

in this country today or we were going to have the barbarians do it their way. Had the Mesa plan been put in place, our company would have about $11 billion in debt. We have got it under control at $5.3 billion. Obviously, this means that there's a lot of interest to be paid.

Now you either believe in long-term growth, you either believe in the concept that the purpose of retained earnings is to permit growth and you simply want to take the position that every so often you ought to milk the machine by yanking the retained earnings out, what I call the warm blood of equity, sir, and replace it with the cold, chilling, and frozen water of debt, you can do that. A jackass can do that. That doesn't take any brains.

But it changes the fact that the company is no longer as strong a force as it was for leadership in technological production, risk taking to make this country a better place to live and to provide jobs, and that's what we have been doing every since I came with the company, sir, 46 years ago.

So what's happened is that we are probably going to change our budget level, our reinvestment level, from something in the area of $1.8 to $2 billion a year to a level of somewhere between $1.3 and $1.5 billion a year. I can assure you, sir, that's not in the best interest of this country.

Senator PROXMIRE. Is that going to reduce your research?

Mr. HARTLEY. We are going to try to avoid that at all cost if we can because, obviously, that's what we need more of to create more investment opportunities of better quality in order to take care of this silly debt that we now have in our system. My friend on my right here talked about the Japanese and the fact that they operate with four or five times much more debt than we do. That's true. But do you know why? Because they have got an entirely different relationship between Government and business.

In the first place, they allow price fixing. That's not too bad a convenience if you want to have lots of debt. Second, when I explore against the Japanese out in the South Pacific, you know how those oil companies get their money for taking risks in exploration? Well, they borrow that money at about 5.5 percent from the Japanese Government and if it's a dry hole, the whole thing is a bust, the loan is canceled.

So we start talking about the economic system in Japan versus the United States and you've got to forget it. They cannot be compared. I know. I have operated in Japan. I was an investor in Japan and I finally decided that Americans weren't wanted there. Why? Because they like their little compact unified, very dynamic system, to reduce costs if at all possible and to put themselves in the strongest position they could to dominate the exports of the world, and that's what they have done. At the same time they have not been doing that which we've been going running around like a bunch of chickens with our heads cut off destroying some of our finest companies.

If we were a lousy company and had terrible management and had a record of declining earnings, maybe there should be mechanisms—maybe we should have been attacked. That was not the case. As a matter of fact, you can't make any money when you raid a bad company. You can only raid a company that's got some

value. We operate between 16 and 18 percent debt/equity ratio. We've run up as high as 30 or 40 percent during periods when we had tremendous investment opportunities. We've used leverage. We know what leverage is all about. There's no monopoly on that.

But I want to point out to you that the reason that South America is in the mess today is because they're leveraged damned near 100 percent and we've got forces in this country that are trying to do exactly the same thing to the industrial capacity of this country and based entirely essentially on a debt system. When you do that, my friend, you do not have stability. You can't take downturns in world crude prices and competition and you become just what South America is—impotent.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up.

Senator HECHT. Mr. Hartley, you mentioned 10 minutes. It's been 15. If you have to excuse yourself, we understand, or do you want to take another question?

Mr. HARTLEY. I'll take one more question, sir. I'm not trying to be funny about leaving early, but we've got some funny customs in the world and the London airport closes at 11 p.m., even though it's a marvelous international airport. I think they want the queen to sleep at night.

Senator HECHT. Senator Gramm.

Senator GRAMM. I want to ask Mr. Hartley a question, but let me begin with a very short question for Mr. Pickens.

When you decided to try to buy Unocal, what was its common stock selling for?

Mr. PICKENS. The first stock we bought was $37.

Senator GRAMM. And in your takeover offer you offered $54 a share?

Mr. PICKENS. That's correct.

Senator GRAMM. And Mr. Hartley, in your position with the company and as a steward of the well-being of the stockholder, how is your stockholder better off today because you fought off that $54 a share offer?

Mr. HARTLEY. Well, of course, as Mr. Pickens has admitted, if he had won the battle, there wouldn't be any Unocal shareholders any more.

Senator GRAMM. Well, they would have $54 a share.

PRESENT PRICE FOR UNOCAL STOCK

Mr. HARTLEY. He was basically on a leveraged buy-out case. He would end up with all the stock other than what he has in his own little company. And that was his game plan.

Now, to answer your question, at the price that our debentures that we will be issuing and are now trading and have been for 3 weeks, they are of high quality, the assets of the company are behind them, they're ahead of all others, and they are trading at $75 a debenture unit versus an assigned value that we thought they would be traded at $72 a share. So 39 percent of the shares that our shareholders have were tendered. They've got 39 percent at $75 a share, which is a value of $29.25. And 61 percent, that's the rest of their shares, are trading as of the close yesterday, sir, at $30.50, which was $18.65. That's a sum total of $47.90 and they

were trading in the area, before Mr. Pickens got busy, in the area of general tradings between about $33 and $38 a share in the marketplace, that is in the prior 3 or 4 months.

Our shareholders will still be able to participate. They've still got 61 percent of the stock in their hands and they've got this value of having sold 39 percent of the stock for $72 and I can assure that we have people that had bought our stock in 1960 and paid $2.60 a share for it and it was $37 a share prior to the disturbance in the marketplace that we experienced, I can assure you it's not the plan of this management to not have it grow again and again and again as it has in the past.

Why? Because we have committed ourselves to growth. We are not trying to liquidate the company. That's not our job. The job of management is not to liquidate itself, and if a company is in that frame of mind, then I think it's time they had new management.

Senator GRAMM. What is the job of management? I hear you talking about developing resources to help the Third World.

Mr. HARTLEY. Yes.

Senator GRAMM. I hear you talking about investment for growth's sake. I didn't hear you mention profit.

Mr. HARTLEY. Well, it goes hand in hand. You can't do all these things if you don't have profit. That's what retained earnings is. You pay out some dividends and—incidentally, on that stock that those people bought in 1960 for $2.60, we've had that many stock splits, they're getting a dividend on that investment of $2.60 of $1.20 a year.

Senator GRAMM. But I still don't understand how they are better off today than they would have been—they, being the stockholder—if the offer of Mr. Pickens of $54 had been accepted they would have the $54 a share, Mr. Pickens would have the company. If he couldn't do a better job than you were doing when the market valued it at $37 a share, he would quickly be broke.

Mr. HARTLEY. Sure, and the company would be down the tube and there would be 22,000 people out of work—a marvelous concept. We're trying to defend this country and defend this company and this country from having that happen. Under the Pickens proposal, my friend, it's true, 49 percent would have gone out at $54 a share in cash which is gathered up from a whole bunch of outfits looking for fast bucks.

Senator GRAMM. But they believed they could get the fast bucks because they believed that in fact that he could be successful in the process because if he wasn't they not only could lose their profit—not only lose their interest on these so-called junk bonds but they could lose the principal as well.

Mr. HARTLEY. Senator Gramm, you haven't followed the complete circle. There's no question that the bonds issued for the first 49 percent, which includes part of that was bank loans——

Mr. PICKENS. 51 percent.

Mr. HARTLEY. 51 percent, that's correct. 51 percent. That would have been pretty secure junk bonds. It's the rest of the deal where the shareholders are being told you're not going to get cash for the other 49 percent, we're going to print some money for you, there are going to be—I think they had three different combinations of debt certificates—and there's very little behind those in value be-

cause the company's debt would then have been pushed up to $11 billion as we totalled it up, and at that point I can assure you Unocal becomes unstable and the only way you can defend it is to sell off good assets because nobody wants to buy your bum assets. And I might say we don't think we have too many bum assets.

Mr. Pickens doesn't think refining and marketing are very important. I don't know what the hell crude oil producers would do if there wasn't refining and marketing in this country. Obviously you would have to pump it back into the ground, otherwise you would be drowning in this stuff.

So it's true, we're integrated and have been for 95 years. We have been creating markets for crude oil producers including ourselves.

It's the back-end of that deal that is very susceptible—you have to be very suspicious of its value.

Mr. PICKENS. May I comment?

Mr. HARTLEY. So as a result of that, sir, you've got an unstable situation. We have given our shareholders $72. We have extracted $2 billion of equity in a $2 billion premium. In other words, the stock was selling at $35 to $37. We have issued 39 percent of the stock at $72, which is double the market price. You can't tell me that our shareholders didn't get damned good value on 39 percent of that stock.

They have now got a chance to have it happen—to have our company grow again and they to be a participant. I think the proof of the pudding, Mr. Gramm, is that I happen to believe in a democracy too. There's no monopoly on that in England or France or anywhere else. And our shareholders, leaving out Mr. Pickens' vote which obviously was prejudiced, was 2.8 to 1 in favor of the management of the company, and taking the individual shareholders, those people like you and me, not the institutions that are playing with our stock market day in and day out like it was a Las Vegas operation, voted in favor of the management 8 to 1. So you can't tell me that a decision wasn't made on a democratic basis on the part of our shareholders to not delay our annual meeting, to not have more proposals put on the table by Mr. Pickens. Our shareholders made a decision with the management in a very straightforward, democratic basis.

Senator GRAMM. Mr. Pickens, you wanted to respond to that?

MESA'S OFFER TO UNOCAL SHAREHOLDERS

Mr. PICKENS. When he's talking about a vote, it was a vote for adjournment. It didn't have anything to do with our offer. Our offer never got to the shareholders because of the Delaware decision. But the $54 that Mr. Hartley testified to, that was the 51 percent that was cash—he accepts that. The 49 percent on the second step was also $54 on paper. What Mr. Hartley leaves out is that we had given a letter to Mr. Hartley and the board of directors of Unocal that the $54 would be evaluated by outside investment bankers and it would have a value of $54.

So what we were offering was not a two-tiered offer. We offered $54-54, which is exactly what it was. Your point, Mr. Gramm, of what was the difference, it has cost the Unocal stockholders some-

where around $2 billion because they were not allowed to take the $54 offer.

Now the underlying values for the debt. Again, we were going to have the outside investment bankers agree that they would value that paper. Mesa Petroleum's stockholders would have had $1.7 billion under that particular credit. If we had lost—if those people had lost, Mesa would have lost $1.7 billion first. I think most of you know something about our past activities. We don't go around losing $1.7 billion on anything. So our money was in ahead. We would have lost first before anybody else would have lost in the Unocal deal. So it was very clear cut and straightforward as to what we were doing. It was just a case of entrenching management and we unfortunately got the call in Delaware that we did and therein we were discriminated against as a stockholder. I think if you just look at today's Wall Street Journal on the editorial page, "Review and Outlook," it has an interesting comment. It says:

> For our own part, the more closely we look at hostile takeovers, the more we are convinced that while there may be occasional problems and abuses, they are generally a healthy activity. Capital structure needs to evolve and we certainly are not willing to leave the evolution solely to the incumbent management that represents the old order. We find ourselves sympathizing when in defense of his controversial activities Carl Icahn argues that we would not have the rust belt today had it been possible to pierce the establishment in the steel industry 20 years ago.

I think that same situation exists in the oil business today.

Senator GRAMM. Thank you.

Senator HECHT. Senator Sasser.

Senator SASSER. No questions at this time.

Senator HECHT. Senator Gorton.

Senator GORTON. No questions.

Senator HECHT. Since I gave up my time, I just want to ask one question to Sir James Goldsmith. It's a philosophical question not on this.

With this philosophy that you have that's found during this speech, how come you stayed in Europe and did not come to America many, many years ago?

Sir JAMES GOLDSMITH. Very good question, Senator Hecht. Stupidity actually. The main answer is that people are not aware of lack of freedom until they taste freedom, and I was never aware of the inhibitions and constrictions in Europe until I fully tasted those on the other side in America.

But, Senator, if I may, with some frustration I have listened to my friends here and I particularly wanted to say something. Can I use this opportunity to answer one or two points that have been made?

Senator HECHT. Of course.

Sir JAMES GOLDSMITH. Thank you. I would have liked to have said this when Mr. Hartley was here. Mr. Hartley talks about mergers and raids, mergers being good and raids being bad. He talks about two-tiered tender offers being necessarily bad. The difference in his definition between a merger and a raid is whether it's hostile. I'd like to analyze that word. Hostile to who, Senator Hecht? Hostile to the entrenched management, not hostile to the shareholders. Who's calling it hostile? The owners of the business? They should decide. It's only hostile because those who mistakenly

have come to believe that they own the business, they don't want to give it up and that is why it's hostile. There's nothing hostile about a hostile bid. There's no difference between a raid and a merger except that the established bureaucrat loses his job, not the owners and not the business.

The second point is that if you just analyze the news of the last few days you see that R.J. Reynolds, a great establishment corporation and I'm not attacking them in any way, made a tender offer to merge with Nabisco, two-tiered, front-loaded. What's the difference? The only difference is the Nabisco management has been reassured as to its future tenancy in the management structure. Why does that make it better or worse?

This whole world—the whole game has been changed to bring in buzz words which are deformed. The word hostile is merely a bureaucratic term to try and create a nobility to entrenchment.

DEBT IS NOT NECESSARILY EVIL

The final point is everybody talks about debt as though debt was a terrible thing. Nobody likes debt particularly, though it's quite a stimulant. But nobody ever talks about the fact that there's a huge free marketplace out there and a company that establishes debt and is successful can recapitalize itself. It can go out to the market and issue shares and pay off that debt. It's as though debt was a permanency. It's as though once it's been taken on it can't be taken off. This is nonsense. There's a huge free marketplace for recapitalizing debt. There's nothing permanent about debt unless you're unsuccessful.

The final point which was the point talked about by Mr. Hartley here was when he talked about—and I don't want to get involved in the Hartley-Pickens battle and I did not attack Mr. Hartley's management and I never mentioned it. I stayed quite clear of it. But on the one point of what happens if Mr. Pickens' company acquired it and it had gone down the drain and 22,000 people would have lost their jobs, that's just not true. It's Mr. Pickens who would have lost his job. That company wouldn't have closed down. It wouldn't have disappeared. He would have had to sell it to somebody who would have managed it if he failed. That was just a demagogic point.

Senator HECHT. Boone, this guy does a better job of talking than you do. You ought to take him with you. [Laughter.]

Mr. PICKENS. I would agree with everything he said. It's so refreshing to hear Sir James articulate these points because as I heard Mr. Hartley go through several pages losing the point from time to time and shuffling back and forth I kept trying to think where have I seen this before, and I remembered the book, "The Caine Mutiny." I don't know whether you remember that or not, but I thought there was something analogous here to Captain Quig. [Laughter.]

Senator HECHT. Sir James, personally I would like to invite you to be an American citizen and join the Republican Party. You could be one of our top spokesmen.

Senator Gramm asked for a couple more minutes.

Senator GRAMM. Sir James, I just wanted to ask you a question. Let me begin by saying that to me this is an issue involving the growth of the country, the dynamics of the country, and the productivity of American industry. It's not a matter of personalities. I have to admit as I sit here listening to Mr. Hartley talk about the share selling for $2 and some odd cents 20 years ago, my guess is that 20 years ago he would have adamantly opposed every proposal that's been made by the company today.

But I'm interested from your perspective from Europe, and you've done great service to this country today whatever money you've made here, I hope you make a lot more since we'll get a hefty share of it—you have more than paid us back by what you have done today in bringing an outside perspective on the problem.

But I wondered as I listened to the arguments today about helping underdeveloped nations, balance of trade, protecting jobs—are those the same arguments that established interests in Europe used every time they asked for government protection or government subsidies?

Sir JAMES GOLDSMITH. Senator Gramm, I've heard it all before and I've seen the decline of those who follow those demagogic paths. The testimony I gave today when I prepared my statement, was based on something which I said in 1972 in France and it was considered evil. At that time there wasn't a Socialist and Communist government. It was Giscard D'Estaing who was the Minister of Finance. The whole culture of the country didn't understand neither those of the opposition nor those on the left, did not understand what free enterprise meant. The whole idea that a rotting company in the hands of establishment bureaucrats should be able to be restructured was considered somehow evil. Things have changed since then because they've had 5 years of socialism which has taught a lot, but all these arguments I've heard over the last 25 or 20 years. They are a formula for disaster.

That doesn't mean there are no abuses in takeovers. That doesn't mean there are not going to be bankruptcies. That doesn't mean that people are not going to take on too much debt. Of course that does not mean raiders are doing it for any other reason than personal gain. Raiders shouldn't put on a halo. They are doing it for personal gain. The important thing is whether their action is generally beneficial or generally detrimental, not why they are doing it.

But those arguments from establishment companies: Long-term research, major investment, the Third World thing—what has happened? All those same companies today are sterile, losing money, not investing. When there is major investment it's to contract and shrink their companies, it is not to grow. So they are all old arguments as far as I'm concerned.

Senator GRAMM. Well, I'll just close, Mr. Chairman, by noting what a great tragedy it is in the great economic system that capitalism has ever built when we hear business people argue about everything except the job of management, which is to earn profits. We hear arguments made on behalf of the national interest for exports and job protection and investment and research and development, but it's obviously considered in this great capitalistic Nation somehow a weak argument to say that we're trying to make money

when, as all of us who have studied this great economic system know, that is the fuel that moves the hinges that built this country and that promises it a bright future.

Sir JAMES GOLDSMITH. Could I comment on that, Senator?

Senator HECHT. Please do.

Sir JAMES GOLDSMITH. There is one typical example. I've watched some of the testimony before this subcommittee on videos because I wanted to understand how it worked, and I saw testimony against leveraged buyouts and I just wanted to give one example which is an example given to me by one of the leading commercial banks in this country.

EXAMPLE OF A LEVERAGED BUYOUT

There was a major conglomerate, a tire conglomerate. I have been told not to give the names of the actual companies. They had a subsidiary and the subsidiary was a stable subsidiary, reasonably well-managed, producing reasonable cash flow, no great growth expectation. So this major corporation, major conglomerate, kept on tying down that subsidiary—bring down expenses, bring down overhead because they are not going to have growth out of this company, but at least they argued let's have cash flow out of it.

The management of that company who had really reduced overheads to the minimum one day went to the management of the parent conglomerate and said, "Can we buy it with leveraged buyout?" They were financed by this commercial bank. They bought the company and within a question of months overheads had been reduced by a third. Within a question of a number of further months the company started to grow. It made a number of minor acquisitions to round off its activities and it is now one of the most successful companies and growth companies in its field.

What this shows, this one story—and I wish it could be documented—and there are so many others—that the dead hand of the bureaucrat does not produce growth. It does not produce innovation. It produces complacency, ossification, and decline. When you have a leveraged buyout with debt but having the people who are running it with a major stake in that company, you get the opposite. The idea that big capital and no debt is a stimulant to growth and innovation is a totally false idea.

Senator HECHT. Senator Cranston, you just came in. If you have any questions, we're going back for a second round.

Senator CRANSTON. I have just one I'd like to ask Mr. Pickens. It's been alleged that the Tax Code is not neutral to hostile takeovers and leveraged buyouts but that the Tax Code actually encourages them with favorable treatment on the writeoffs of debt and interest on financing.

I'd like to know, Mr. Pickens, how you would respond to the statement made by Fred Hartley of Unocal, "The taxpayers of the United States should not be forced to pay part of the cost for a raider's course of action," and that we should consider an end to deductions of interest cost on money borrowed for this activity?

Mr. PICKENS. I think that's a statement that would be typical of entrenched management to make. If we're going to start out taking the interest here, then, we're talking about how did you buy your

car. I know how I bought mine and my home. It's the same. We get an interest deduction. It's the same way when you make other acquisitions. So the interest that's paid certainly goes into the profit column of a bank or a lending institution and they pay taxes on that. So you do get a deduction for the interest. If you want to take it away, you're going to just change the values. That is what will happen.

Senator CRANSTON. Thank you. I have no further questions.

Senator GRAMM. The Chair recognizes Senator Gorton.

Senator GORTON. Mr. Goldsmith, I did not have an opportunity to listen to your opening statement but I have read it. On page 6, where you make the obvious statement that management is employed by the shareholders to look after the shareholders. You list a number of the defensive tactics in takeover battles, descriptively rather than critically, and state that they ought to be approved by shareholders rather than being used at management's discretion.

In regard to one such defensive tactic, greenmail, I wonder if you would tell me whether or not, in the present status of your battle over Crown Zellerbach, you would consider accepting a greenmail-type purchase and whether it would make any difference if that offer came from management or from a vote of the shareholders themselves.

Sir JAMES GOLDSMITH. Senator, in the case of Crown Zellerbach, let me answer the particular point first. At the first meeting I had with the chairman, Mr. Creson, I said that we would not accept greenmail and that was registered with our filings with the SEC in 13(d) filings.

However, we went further because that's a statement of intent and it's not legally binding. We also wrote a letter to Mr. Creson and his colleagues saying that we would not accept greenmail and if we sold our shares to the corporation other than within the context of an offer made to all shareholders the profits on our shares would be available to all other shareholders pro rata to their holdings and that they could sue us under that commitment.

So we went further and made that legally binding rather than a statement of intent.

Senator GORTON. And that remains the situation?

Sir JAMES GOLDSMITH. That is the position today.

Now on a more general basis, greenmail, rather like the word hostile, is again another one of these buzz words. What is greenmail used for? Greenmail is for entrenched management which wants to buy off, with other people's money, somebody who is a threat to their position. I'm not trying to suggest that raiders don't want greenmail. I'm not suggesting we're not tempted by it if offered it. But really what is happening, it is entrenched management paying with other people's money to get rid of a possible threat to their positions.

Now sometimes buying a block of shares into the corporation is a good thing. Sometimes a reduction of capital is a good thing. Not long ago there was an article in Fortune magazine which analyzed companies which bought back—had done so consistently—shares of their own company and they did so either by using their cash-flow or—which is a wise thing to do—selling off companies which are constituent parts of their company but which perhaps no longer fit

into their strategy or which no longer have growth or which they have problems with or are incapable of managing. They have sold them off and shrunk their capital.

GONE TO VALUE RATHER THAN SIZE

If you look at the record as stated in Fortune magazine, you would find that those companies that have done that have done consistently better than those which have not. In other words, those who have gone for value rather than size, the traditional conflict of interest between shareholders and management—management wanting size and shareholders wanting value—those companies that have regard for value have done consistently better for their shareholders.

So sometimes a company might want to buy a block because it's a good thing, but they should do it with shareholders' approval. I am not suggesting that greenmail is something evil, if you mean by greenmail buying back a block of shares in the market, which is what it really means. What I'm saying is, that could be good, but it should be approved by shareholders because there's a potential conflict between management and shareholders about it.

If I may just address a question that Mr. Pickens answered just now about tax, when a company buys in its own shares, it is doing what somebody from outside would do if they came into that company—sell off the nonsense and shrink the capital. If they shrink the capital with debt, the interest on that debt is partly offset by tax. It is only within the context of this hostile idea that people worry about the interest being deductible for tax. As I said, the word hostile is itself an artificial word. Hostile to who?

Senator GORTON. Would the answer which you have just given with respect to greenmail apply equally to the kinds of spinoff operations in which Crown Zellerbach is engaged in at the present time?

Sir JAMES GOLDSMITH. Senator, there are two kinds of spinoffs. Crown Zellerbach was a conglomeration of companies. It is not traditionally looked on as a conglomerate but it is nonetheless a conglomerate. Some of the assets are earning money. Some of the assets are valuable but earning very little return, and I have always said—I've gone on record publicly—that sometimes companies have to be restructured to liberate values because if you take the case of timber companies in which I have been more involved you find that timber holdings in corporations are usually held by very old corporations—I think Crown goes back 114 years and its timber holdings are on its books at an almost nil value. It is very comfortable for management to be able to have vast resources in its books for almost nil because when it cuts that timber and uses it as a raw material in its manufacturing operations it does not have to charge itself market value for that raw material but historic value in its books. It's as though Heinz when it made Heinz tomato catsup got its tomatoes for nothing, obviously a much easier way of making profits.

But as far as shareholders are concerned, it's a sterilization of a great amount of assets. So splitting off the two and forcing the manufacturing operations to buy its raw materials in the market-

place is a thing which I think is right. I have gone on record before saying that. Therefore I am in agreement with the concept. Where I am in total disagreement is when they issued the poison pill. May I just refer to that.

What was the thinking behind the poison pill? The thinking behind the poison pill is that the board sits down, the board with 0.8 percent of the capital of the company, and they say:

> The issues that our shareholders face are complex, they are economic, they are forecasting, they're complex issue. We the board are wise enough to make those decisions. Our shareholders are not wise enough. So we will appropriate from our shareholders the right to decide on their behalf.

Now if you like to extend that thinking to the political process where the issues are infinitely more complicated in terms of defense, economic policies and the rest, and if we have a government which then says, "We the government are wiser than the voters and we will no longer have elections," we know where that leads. And that is precisely what the poison pill was, sir, and that is why I particularly disapprove of it.

Senator GORTON. Did you disapprove of it exclusively because it was accomplished by the directors rather than by a vote of the shareholders?

Sir JAMES GOLDSMITH. If they had put it to their shareholders and the shareholders had voted to give that power to their board, then it is unarguably legitimate. That is where my testimony comes in, Senator Gorton. It should not be permanent. The shareholders change and directors change. You have at the moment a number of life tenures being created in U.S. corporate management. It's already been created in Europe, I can assure you, and for a long time. I'm talking about what is happening here. You take, for instance, supermajority votes. I was reading the prospectus of a company or a proxy of a company the other day where foundations and individuals had a little over 25 percent—a major company—they had a little over 25 percent of the shares in that company. They put in supermajority voting rights whereby you need over 75 percent to do almost anything in that company.

What is the result of that? They say it in their proxy. They say, "We've got over 25 percent but in future to do almost anything you're going to need 75 percent vote." That is entrenchment for life. That is disenfranchising the other 75 percent.

Now the other 75 percent might vote for that today and the management might be good today, but with the passing of time shareholders might change and the performance of management might change. What I'm suggesting is that if there are entrenchment devices, yes, they are legitimate if approved by the shareholders; no, they are illegitimate if unilaterally imposed by management. But even when legitimized by a shareholder vote, there should be a regular vote on it yearly or every 3 years so that it is not life tenure for management.

Senator GORTON. When a corporation like Crown Zellerbach engages in this kind of activity, do you have a right simply to concentrate your ownership in one of the spinoff companies?

Sir JAMES GOLDSMITH. It depends on the mechanisms that will be established. In fact, we're meeting tomorrow to discuss this point so I can't really comment on the mechanisms. But normally speaking,

all shareholders would be treated pari passu and that is an issue we will be fighting for.

Senator GORTON. Thank you.

Mr. PICKENS. Except for the *Delaware* decision.

Sir JAMES GOLDSMITH. That's correct.

Senator D'AMATO. Senator Proxmire would like to ask a question. I have one question that comes to my mind.

ONE SHARE ONE VOTE

We will be making a little announcement before the next panel. It's an issue of one share one vote. Should it be? Should we have the kind of situation where you have the supershare which can vote 10 times that of the other? Do you have any thoughts on that?

Mr. PICKENS. I do.

Senator D'AMATO. Boone.

Mr. PICKENS. Mr. Chairman, I can't believe how far this has gone in the wrong direction in this country. We have lost sight of what I believe to be the main event. We talk about the Unocal deal. We talk about the Crown Zellerbach deal. We talk about TWA and we talk about all the different companies. The one point that should not be lost and the primary bent for all of this is who is it that owns the company? Is it the stockholders or is it the management of the company?

This has got to be established at some point or the credibility in the capital markets is going to be progressively poorer all the time because stockholders will feel more comfortable in municipal bonds or whatever else, but they're not going to go into companies that have supermajority votes where they are not going to have the same rights. Their vote looks like everybody else's but it doesn't have the same rights as everybody else's. So when you talk about one vote one share or whatever, I mean that's a system that we all grew up under. That's the system we live under supposedly. And to start giving somebody special treatment to have more votes or less votes or whatever else, that isn't the way it's supposed to be in this country.

So, to me, it's a clear-cut situation. If we all agree that the stockholders own companies, then they ought to be able to vote their shares. They should have the same rights as all other stockholders. Second, they should be able to decide. I personally have a lot more confidence in stockholders deciding the issue than I do managements deciding issues. When you line up the conflicts, the conflicts are lengthy on the management side and very short on the stockholders' side. Stockholders do own the company.

Senator D'AMATO. Sir James.

Sir JAMES GOLDSMITH. I agree with that, Mr. Chairman. All shareholders could have one vote. I can see, as I mentioned before, that there should be special rights for special actions approved by shareholders in a prior meeting but they should be regularly submitted for voting. I know that you will be talking to the leaders of the stock exchange. One of my worries is that within the context of competition between the stock exchanges there have been stock exchange rules like not issuing more than 18.5 percent of the issued capital without shareholder approval, so as to maintain a quotation

on the New York Stock Exchange. Within the context of that rule a number of companies have been saying, "Well, so what? We'll just leave the New York Stock Exchange and go over to NASDAQ." It seems to me then that that rule loses its bite. And if that rule loses its bite, management, regardless of shareholder interest, can issue any number of shares, change control of the company, put it into private hands, public hands, issue them at any price, without any kind of action by shareholders being possible because up to now it's not been a legal requirement but a regulation of the stock exchange. If they're willing to abandon the New York Stock Exchange and go over to NASDAQ, it takes the teeth out of that.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Pickens, I assume you've read the May 6, 1985, issue of Business Week, but after reading a few excerpts I would like to give you the opportunity to answer the basic question posed: "Does Boone Pickens Practice What He Preaches?"

The article says:

> Mesa Petroleum Co. Chairman T. Boone Pickens, Jr., has just finished another sermon on the sunset oil industry and its wastrel leaders. It was a well worn speech on how big oil companies are liquidating themselves and should share their huge cash flows with stockholders.
>
> The meeting was packed with independent oilmen in awe of the messenger of doom for Cities Services, Gulf, Phillips—and now perhaps Unocal. Still, there was one doubting Thomas. From back in the crowd, he asked: "What are the Mesa shareholders getting out of all of this?"
>
> The question follows Pickens everywhere these days, as Mesa's stock trades at about $17 a share, up almost 30 percent from early 1984, when it looked as if Gulf Oil Corp. might escape from Mesa and leave it with big losses. But it is down from $22 last December and is only half of the 1981 high of $34.
>
> Meanwhile, Pickens has emerged as the highest paid executive of any public company, earning $22.8 million last year. "He's gone too far," chides one Mesa alumnus. Pickens retorts that he is getting his just rewards: "I've never questioned a corporate executive making money for stockholders, and I make a lot for stockholders."
>
> The facts, though, don't support his claim. Even though Mesa posted a 34.2-percent return on equity in 1984, it yielded only a 7-percent return to shareholders in the past 3 years. Pickens' millions made him the CEO who produced the lowest profits and shareholder gains for his pay.

What is your response to that?

A 34-PERCENT PRICE INCREASE IN MESA STOCK

Mr. PICKENS. Well, to go back to your statement, we made a 34-percent increase in the stock price over the year 1984. That was what I was paid for. The $18 million was a deferred compensation pool that was set up. My part of that $20 million pool was $18 million. That was specifically for the results in 1984. That was not something I asked for but it was designed by the board of directors and I honestly have not read the full text of the agreement. But I appreciated it and it was for the results of 1984.

You say we've done less for our stockholders than anybody else. I think that may be taken out of context because that was over a 3-year period. If you take the oil industry and look at it over 1982, 1983, and 1984, which were 3 horrible years for the oil industry, they are comparing my deferred bonus there to companies that were not in the oil business.

Senator PROXMIRE. Mr. Pickens, I think you must appreciate the effect of a $22 million compensation in 1 year. You take all 100 Senators, we make $75,000 apiece, that's our pay, multiplied by 100, that's $7.5 million. You made three times as much as the entire Senate. You made 100 times as much as the President of the United States.

Senator D'AMATO. That's good.

Senator PROXMIRE. Well, maybe he's worth it. Maybe that is a comment on the Senate, too, I suppose, and on the President perhaps.

Mr. PICKENS. May I comment on that?

Senator PROXMIRE. Yes, sir.

Mr. PICKENS. Let me take you back to 1964. I was the founder of Mesa Petroleum. I have no founder's stock, which should make you wonder about my IQ. If you take me and compare me to other founders of companies the size of Mesa Petroleum, my compensation would not be unusual. For instance, I never make the Forbes 400 because I had no founder's stock in Mesa Petroleum.

I was given an opportunity in 1979 after we spun off the Mesa royalty trust to the stockholders—we released half of our reserves to the stockholders. My incentive at that time was that the directors gave me an opportunity to bring my ownership up to 10 percent of the company. At that point I owned about 2 percent and my option—I'm giving rounded figures here—was about 8 percent and it was for the current price of the stock which was $11.50.

After the 1984 performance in the Gulf deal where the pretax profit to Mesa was something over $400 million, I was given the deferred compensation. It will give me an opportunity to put that money back in the company, exercise my stock option, and bring my ownership up.

So it did have a very positive effect as far as I'm concerned and as far as the stockholders are concerned. The reason being is that I personally, today, have over 90 percent of my net worth in Mesa Petroleum.

Senator PROXMIRE. But you were making $22 million and this article says the Mesa dividend payoff last year totaled $14 million, far less than Pickens' pay. In other words, all your stockholders got only two-thirds of what you got in compensation.

Mr. PICKENS. Senator, I told you that was a deferred compensation. They got the $14 million in dividend. I got zero in money at that point. But if you look back over the period 1984 and what we have brought into the company and what I have managed and what I have directed—let's make another point here—that in the Gulf Oil deal, Gulf's two investment bankers, which were Merrill Lynch and Salomon Brothers, received $63 million for their part of that particular transaction. Our investment bankers got $7 million. In the Phillips deal, the Phillips investment bankers were paid $35 million and we had no investment bankers. Our investment banking was zero. It was done in-house.

So if you say that we provided the investment banking function in those two transactions, it was $99 million for investment bankers on the other side and $7 million for the investment bankers on Mesa's side, plus the Mesa management. So it was cheap for our stockholders in that case.

Senator PROXMIRE. In the past you have been very vocal and you have been today too in your criticism of entrenched management and with respect to management entrenchment defenses. Yet I read that Mesa has had its fair share of protections.

Forbes, for instance, said the following in its April 22 edition:

As we said, Ol' Boone takes mighty good care of himself. For a man who regularly denounces takeover defenses as protecting lackadaisical managements, Pickens has installed an impressive array of them at Mesa, including staggered terms for directors and supermajority provisions that practically ensure that no one can take control of Mesa without Pickens' approval. But when they introduced the new deferred compensation plans, Mesa directors added a doosey of a shark repellant: If the special compensation committee or the Mesa board determines that a change of controls is even likely to occur, the restrictions that limit Pickens' ability to cash in his deferred chips fall away.

Then another legal publication reports:

Pickens sits at Mesa behind a barbed wire net of antitakeover protection devices, plus a fabulous golden parachute at the ready should the protection fail. In other words, in a rational world he'd be cast as a selfish, entrenched manager.

LEGITIMATE OFFERS

Mr. PICKENS. May I respond, please? I'm on record at least 25 times saying that if there is a legitimate offer from Sir James or anybody else for Mesa Petroleum, that all of the golden parachute goes off, all the entrenchment goes off, the offer goes directly to the stockholders. I will not spend one dime to keep that offer from going to the Mesa stockholders.

Senator PROXMIRE. Who defines what is a legitimate offer?

Mr. PICKENS. The premium to the market is the definition.

Senator PROXMIRE. Just on the basis of whether the stockholders would profit?

Mr. PICKENS. That's right, exactly. That's who I work for. We will remove all that. The reason it's there is because when we make a move on a company like Unocal or Gulf or Phillips or somebody else, we have to have some time built in if there's a counter tender offer for Mesa so it does not take us out of the picture before we can go ahead with our offer. That's the only reason that's in.

Senator PROXMIRE. I have one question for Sir James Goldsmith. Sir James, we're happy to have you here.

On April 22, 1985, William Creson, chairman and chief executive officer of Crown Zellerbach, testified before the Senate Finance Committee and spoke of your attempt to take over the Crown Zellerbach Corp. He compared you to the men who pillaged in England and Ireland in the 9th and 10th century. Essentially, he said that you and the other takeover raiders create no real wealth but rather take over assets painfully built by others, split them up, destroy the company and leave pillage in your wake. He said the takeover process is simple and understandable. Spinoff units and splitoff plants that are now closely related, sell them piece by piece for a total price which is well above the raider's total cost, pay off the junk bond debt. The cash balance plan of any remaining assets on the sale represents the raider's profit.

Mr. Creson not only describes you and other raiders as destroyers of entities that built our Nation's long-term wealth, but he also

notes that because of your complex web of tax haven based offshore entities it's not clear whether you pay any U.S. income tax on the profits made on your pirating. Earlier you were commended on paying taxes to this Government.

My question, Fortune magazine reports you made a gain of over $500 million on the acquisition and breakup of the Diamond Limited Corp. Did you pay any U.S. income taxes on that?

Sir JAMES GOLDSMITH. Senator, as soon as our corporations invest in United States corporations, they pay U.S. income tax.

Senator PROXMIRE. Did you pay income tax?

Sir JAMES GOLDSMITH. I am a citizen of the United Kingdom and live in France and England.

Senator PROXMIRE. So you didn't pay any income tax?

Sir JAMES GOLDSMITH. Personally I did not. The corporations did.

Senator PROXMIRE. You made $500 million and you paid no income tax to the United States; is that right?

Sir JAMES GOLDSMITH. No; that is not right, Senator Proxmire. First, I did not make $500 million that is in the Fortune magazine article. I would have loved to make that.

Second, it was the corporations that made the profit, not me, and they pay out a dividend. I receive that dividend. Those corporations are subject to U.S. tax. The corporations that trade in the United States are subject to tax just like any corporation in which anybody else would be involved in. That I am based offshore is correct. I started my statement by saying I'm based in Europe. Until 1981—I started in business in 1954 when I came out of the British Army in 1953 and I started my business in France and from 1953 until 1981 I was based on a French corporation. It was clear to me there was going to be an emergence of a socialist government in France and I decided to create an alternative base if that were to be the case. I created the alternative base outside France based in Cayman and that is a public company whose shares are traded on the London Stock Exchange and when that company invests in the United States any funds transferred to the United States and invested here in corporations, then those corporations are subject to the United States tax structure.

Now I'd like to come back to Mr. Creson's more general remarks which have an element of truth. Somebody going in to buy a company can buy a company for one of two reasons—one or two principal reasons. The first is to build on it. I have been a grocer for 35 years and if I buy a grocery business it's to try and build long term on that business and, therefore, that is a traditional strategic acquisition in an industry in which one can make or lose money. We have lost money substantially on occasion. We have made money substantially on occasion. Net, we have made. Otherwise, I wouldn't have been able to afford my ticket here.

There's another aspect of takeovers, and Diamond is a good example, the one you just mentioned. If I may, I'd like to describe the effects of the Diamond restructuring because I think they are very fundamental.

Diamond is an old company. It made the safety match in the United States. It had forest lands throughout the United States. It had a timber base. In line with many other companies in the 1960's it decided that conglomeration was fashionable and it conglomer-

ated. It bought a series of unconnected diverse medium-sized businesses. That was in the 1960's. By the 1980's or late 1970's, Diamond was a tired conglomerate. You just have to look at any of the analyses by any of the major firms of New York analysts and you will find they described the company as a tired, rather sterile conglomerate.

BENEFICIAL BREAKUP OF DIAMOND

What did we do? We bought Diamond and we said we want the forest products business. These other businesses, a mass of heterogenous medium-sized businesses had weakened Diamond and we wouldn't hold on to them. As a matter of fact, we wouldn't be the best people for running them and they should be liberated to other people who can do so and we sold to them. So let's look at those companies. One of them was an extremely well-managed company, had good management, good leadership, good record. We made it public and it became a public independent company and extremely prosperous.

Another one was a reasonably good company which could also be independent. We made it independent indirectly by selling it into a public corporation which had very few other assets.

Another company was a regional canning company, quite well-managed but needed leadership. We sold it in a leveraged buyout to management led by William Simon, who you know, and that has become an enormously successful company.

Another company is a regional paper company in the State of Maine. We sold it to what, in my view, is one of the most dynamic well managed major paper corporations which is called James River in Virginia and that has prospered as well.

Another was a packaging company, a pretty good sized packaging company. We sold it to an Irish company which established itself in the United States which was a leader in the Forbes Record last year.

Each one of these companies liberated from the dead hand of a tired conglomerate has prospered, Senator Proxmire. The management has prospered. The new owners, have prospered and the employees have prospered. We prospered because we did a job. We bought a tired conglomerate. We liberated and we sold the pieces that would be better off independent, kept the piece we wanted, which was the forest products side and which we have not sold. So the profit is a theoretical profit because it hasn't been realized. That is what we kept.

We did it for one purpose—profit. The question is, whether or not it was profitable generally. In my view, our action was entirely beneficial. It has been termed by some of your witnesses as a hostile bustup takeover. If that is so, I am proud of it, Senator.

Senator PROXMIRE. Thank you.

Senator D'AMATO. Very interesting. I wish Mr. Hartley was here.

Mr. PICKENS. It would have been very educational for Mr. Hartley.

Senator D'AMATO. What did you have planned for Unocal?

Mr. PICKENS. Senator Proxmire asked me that question, but, for instance, Unocal had not replaced its reserves. If you recall, back

in 1978, the SEC required all companies to start to publish their reserves and reserve replacement annually. We started doing that at Mesa Petroleum in 1971 and believed it was important in the audited financial statement. In 1978, all oil companies were required to do that. Since 1978 and through 1984, Unocal had never replaced its reserves in any one of those years over that period of time. So Unocal was obviously having a difficult time. All of us do. I mean, it's a tough business, the oil and gas business is. But they had not replaced—Cities Service had not replaced. Phillips had not replaced and Gulf somehow shared their replacement record back beyond 1978 and they hadn't replaced since 1972. So they had not replaced for 12 years.

So these companies are actually—in a stage of liquidation because the primary asset is not being protected. So eventually what will happen if reserves are not replaced and they are depleted from the assets of the corporation, is just a constant erosion of that asset. What happens is that it becomes a downstream operation. It becomes a manufacturing operation at some point.

OIL INDUSTRY RESERVE LIFE INDEX

This should be looked at closely because when you look at the oil industry's reserve life index, if you took 1985 production and extended it out over the group reserves with no additions to reserves, reserves would only last 10 years. So it's an unusual industry and there's an urgency in the industry that is not in—when you start looking at Sir James' operation in the timber reserves, they can be replaced or they have such long life to them you're talking about 100 years supply and the same way with the coal industry. If you're in the coal industry without 100 years supply of coal, you're not really in it.

But in the oil industry you're in an industry which does place an urgency as far as management realizing values for those stockholders and if you think back on it, if the oil industry hadn't had OPEC pricing—and Mr. Hartley mentioned that 20 years ago the price of his stock was $2.60—if we hadn't had OPEC, I wouldn't be surprised if we wouldn't all be $2.60 because OPEC did increase the value of those reserves in the ground. It's a tough business, but I think you should look at it on the basis that there are stockholders here who are totally unaware of the fact that the primary asset of the stockholders is being constantly eroded in a lot of these companies.

One final comment on that. If you take the 10 largest oil companies in America today, none of them are replacing their reserves and they will tell you that they are because they will show some foreign reserves but I'm talking about the domestic reserves base which is the primary asset for the stockholders. If you take those 10 largest oil companies which have 4 million stockholders and you raise the value in the marketplace from 50 percent of appraised value today—that's about what they trade for as a group—if you took that 50 percent and raised it to 75 percent of appraised value—I'm not talking about 100 percent, I'm talking about 75 percent—those 4 million stockholders would be enhanced in value to the tune of $70 billion by the 10 companies. Astounding. And

there's no way that those stockholders are going to realize those values unless those managements decide in some way to allow the owners of the company to cash in on those values before they are depleted.

Senator D'AMATO. Any other questions?

[No response.]

Senator D'AMATO. Let me thank you, Sir James and Boone, for coming in and making this one of the liveliest, if not the most enlightened, presentations. Thank you very much.

We call our third panel, John Phelan, chairman, New York Stock Exchange; Arthur Levitt, chairman, American Stock Exchange; and Gordon Macklin, president, National Association of Securities Dealers.

I'd like to take just a moment to express the problem faced with the three exchanges being represented on this panel, the problem of listing standards or, if I may restate it, the disenfranchisement of shareholders. The New York Stock Exchange has a proposal before it to lower its listing standards and for the first time since the 1920's permit multiple classes of stock with disproportionate voting rights.

This proposal has been called a race to the bottom. It's evident that the New York Stock Exchange faces competitive pressures from the American Stock Exchange and from NASDAQ and currently faces a choice of either lowering their standards or delisting some of the most active stocks.

These competitive pressures must be eliminated and the race to the bottom, I believe, must be halted. I view their current failure to respond as an abdication of their authority. I'm talking about the three.

While I would prefer to see the exchanges resolve this issue on their own, I am leaving nothing to chance. Tomorrow, I will be introducing legislation effective on the date of introduction, June 13, which would set a standard of one share one vote for securities publicly traded and reported in the national market system.

A companion bill will be introduced in the House by Chairman Dingell. I have worked very closely with the chairman of the Energy and Commerce Committee on this issue and it was our hope that he could join us today for this panel. Due to the fact that he's temporarily incapacitated, he will not be here, but I am going to submit for the record a very comprehensive statement from Congressman Dingell.

[The complete prepared statement of Representative Dingell follows:]

STATEMENT OF THE HONORABLE JOHN D. DINGELL
CHAIRMAN
COMMITTEE ON ENERGY AND COMMERCE
ON
CORPORATE TAKEOVERS/"ONE SHARE, ONE VOTE"
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES

JUNE 12, 1985

I want to commend the Chairman of the Subcommittee, Senator D'Amato, for scheduling hearings on this issue. As evidenced by the hearings last month in our Subcommittee on Telecommunications, Consumer Protection and Finance, there is a great deal of bipartisan concern about the continued viability of our system of corporate governance and shareholder democracy.

As takeovers have increased in quantity and competitiveness, corporate raiders have developed creative bidding strategies (front-end loaded, two tier and boot strap) and corporate managements have developed equally aggressive defenses, including the use of two class common.

Since 1926, the New York Stock Exchange has prohibited the listing of non-voting or diminished voting common stock. In a January 3, 1985 press release, the NYSE announced that its Subcommittee on Shareholder Participation and Qualitative Listing Standards had issued a report to the Public Policy Committee of the NYSE Board of Directors, urging the Exchange "not to abandon its tradition of upholding shareholder participation in the affairs of corporations," but nonetheless recommending that listed corporations be permitted to create two classes of common with disproportionate voting rights -- subject to the approval of shareholders holding two-thirds of the outstanding -- whether or not affiliated with management.

With the growth and acceptance of NASDAQ as a national trading market competitive with the Big Board, New York Stock Exchange-listed companies, seeking the protection of two-class common or to further transactions like the recent GM/Hughes deal, are willing to delist if necessary to escape New York's commitment to shareholder democracy. NASDAQ has no such listing requirements nor do most state corporate laws bar the issuance of nonvoting stock.

If two class common is permitted, and becomes widely used, one of the market mechanisms for accountability will be removed and the exchanges may find themselves engaged in a "race for the bottom" as marketplaces compete for listings and trading volume. This point did not elude the New York Stock Exchange's Subcommittee on Shareholder Participation and Qualitative Listing

Standards. After suggesting that the SEC may have authority to establish minimum standards for shareholder participation, the Subcommittee observed:

> [I]f it appears that differentials in such standards result in a significant movement of issuers from markets with rules directed to shareholder participation in corporate affairs to those with lesser or no such rules, then sound public policy may compel the Commission to intervene to protect the integrity of markets and the investors and shareholders of all publicly held companies.

John C. Whitehead, the recently retired leader of Goldman, Sachs & Co. had this to say in a speech on February 2, 1985:

> If the New York Stock Exchange lowers its standards, I fear what has been called 'the race to bottom' will quickly occur, that all companies will move to whatever is the lowest common denominator that the Exchange will permit . . . that corporate democracy as we have known it will disappear.

Arthur Levitt, in May 22 testimony before a House Subcommittee, detailed a number of negative effects -- other than shareholder disenfranchisement -- that will result from nonaction by the SEC and adoption of the NYSE proposed rule change. I believe that his concerns have merit and ought to be considered in any public policy discussion of this issue:

(1) If the vote is taken away or watered down, public investors will in time feel that the cards are stacked against them by some inside group that controls the votes. Before long, they will no longer want to invest in stock.

(2) Much of our nation's wealth and resources will end up in the hands of self-perpetuating private bureaucracies. If we allow management to use this ultimate anti-takeover device, our entrepreneurially driven competitive system of product and service delivery would be weakened.

(3) Outside shareholders will suffer immediate and large wealth losses. Recent instances of creating two classes of common stock with disproportionate voting rights have demonstrated that this is the case.

(4) Severing voting power from equity ownership, the two principal indicia of ownership, will totally distort the concept of a common equity security.

(5) Public shareholders will not receive the benefits of a takeover battle. Rather, they would stand on the sidelines while the voting stock, in the hands of management or a control group, will receive any premium.

(6) Proxy battles will be effectively eliminated and the proxy rules of the Securities Exchange Act of 1934, which are designed to protect and foster shareholder democracy and corporate governance, would be rendered void.

I commend the exchanges and the NASD for scheduling a meeting for this Friday, June 14, in order to explore the basis of a common initiative by the self-regulatory organizations (SROs) on shareholder voting rights. However, in the absence of an appropriate solution by the SROs, and if the SEC remains unwilling or unable to use its authority under 1934 Act Section 19(c) to resolve this problem, then the Congress must stand ready to address the issue. Accordingly, and in light of the compelling public policy reasons, Senator D'Amato and I soon will be introducing companion bills to effect a uniform policy among the principal trading markets concerning voting rights. I thank the Senator for his commitment to this important issue and look forward to working with the Chairman and his colleagues in the Senate on a solution that will best serve the interests of shareholders and of corporations whose securities are or will be traded on the nation's securities markets.

Senator D'AMATO. I would also like to commend my colleagues from California and Ohio, Senators Metzenbaum and Cranston, who have taken an active stand on this issue and will be joining me as cosponsors. We have not begun to move in this area but I would suggest that we will probably be able to line up more than 50 cosponsors and that the sentiment in the House is rather strong for this as well.

I have a brief statement here from Senator Metzenbaum who indicated that several weeks ago he announced his intention to offer a one share one vote bill. Since then he's had the opportunity of working with the chairman to draft such legislation and today says he is pleased to join with me in introducing this legislation to prevent further erosion of the one share one vote principle.

He goes on to say, frankly, I never thought such legislation would be necessary. The one share one vote doctrine has been a fundamental to our system of corporate governance, as the one person one vote principle has been to our political system.

Senator PROXMIRE. Except in the U.S. Senate.

Senator D'AMATO. Correct. But framers of the Constitution clearly spell that out and the fact remains that those people who elect us do that under one vote.

Senator PROXMIRE. My point of course is that New York, with an enormous population probably 100 times that of Alaska, has two Senators and so does Alaska. So it's obviously not one member one vote.

Senator D'AMATO. Certainly, as the Senator points out. I don't know whether that makes us better or weaker, by the way.

[The complete statement of Senator Metzenbaum follows:]

STATEMENT OF SENATOR METZENBAUM

Mr. Chairman, several weeks ago, I announced my intention to offer a one share, one vote bill.

Since then, I have worked closely with Senator D'Amato to draft such legislation.

Today I am pleased to join you in introducing legislation to prevent further erosion of the one share one vote principle of corporate governance.

Frankly, I never thought such legislation would be necessary. The one share one vote doctrine has been as fundamental to our system of corporate governance as the one person one vote principle has been to our political system.

But in the past year, more and more companies have issued a new class of common stock with unequal voting rights. These schemes lodge disproportionate voting rights in management or other friendly hands.

As a result, companies disenfranchise common shareholders and give incumbent management considerable power to run and control the corporation without being accountable to the shareholders—the true owners of the business.

This is not only unfair to common stockholders, it is also an assault on a basic tenet of our economic system—which is based on the broad public ownership of corporations.

This legislation would simply require companies which trade on the major public exchanges and automated systems to have equal voting rights for all holders of common stock.

The bill would allow companies which already have created and issued two classes of common stock with unequal voting rights to retain them.

I want to stress that this legislation will not limit the options or rights of any existing or startup company to issue two classes of common stock with unequal voting rights if permitted by applicable State law. The only restriction is that these companies could not trade on the major public exchanges or trading systems.

I understand that many companies are resorting to these co-called dual class capitalization devices solely to avoid hostile takeovers and, in a different world, would agree with me that such a step is wrong.

As you know, Mr. Chairman, I share their concern about hostile takeovers and have introduced S. 860, the Shareholder Fairness Act, to address abuses by both bidders and targets. But regardless of one's views on hostile takeovers, we should all agree that disenfranchisement of shareholders is simply not a proper way for management to defend itself.

I hope the self-regulatory organizations will see fit to revise their own listing standards so as to maintain this essential element of corporate democracy. But if they do not, or if they adopt a watered-down standard that does not really prevent disenfranchisement, I want to make it clear that I intend to vigorously push legislation to ensure shareholder voting rights, through this committee and, if necessary, directly on the floor of the Senate.

Again, I commend the chairman for his leadership on this issue and look forward to working with him on behalf of America's shareholders in the coming weeks.

Senator D'AMATO. Let me say to you that I hope this provides the impetus that we are serious about this. I mentioned this to Chairman Shad last evening. I called him. I thought I should advise him. I think the SEC should move on this, but in a failure to do this, I am determined to see to it that this legislative initiative is adopted and not because of this Senator, because if anything I have said let's let some time go by. We have waited about 60 days now. We have seen more and more examples of companies moving in this area. I think it's wrong. I think it's counterproductive. I think when the Business Round Table was here last week and their representatives testified and they said they would prefer to have one vote one share, that overwhelmingly this should not be a situation where one takes advantage of the situation because corporations will move to this and if the New York Stock Exchange fails to lower their standards they face the loss of business. That's in a practical sense and I understand that they are placed in a tremendous dilemma. I have talked about that and we will get into that with the panel, but let me open it up to your testimony now, Mr. Phelan.

STATEMENT OF JOHN J. PHELAN, JR., CHAIRMAN, NEW YORK STOCK EXCHANGE

Mr. PHELAN. Thank you, Mr. Chairman. I am delighted to be before this subcommittee this morning.

My name is John J. Phelan, Jr., and I am chairman and chief executive officer of the New York Stock Exchange.

[The complete prepared statement follows:]

TESTIMONY OF THE NEW YORK STOCK EXCHANGE INC.
TO THE SECURITIES SUBCOMMITTEE
OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JUNE 12, 1985

INTRODUCTION

Recent trends in the corporate takeover process have raised many questions about the impact of takeovers on shareholders of publicly owned corporations. The New York Stock Exchange shares the Securities Subcommittee's concerns on this urgent issue that has such important implications for our national economy.

PUBLIC SHAREOWNERSHIP IN AMERICA

The Exchange's leadership in developing and promoting high standards of corporate democracy has played a major role in expanding public shareownership in this country and in helping to build the world's strongest capital markets.

The Exchange's most recent survey of shareownership showed that better than one out of every six Americans --a total of 42,360,000 individuals-- directly owned shares of corporate stock or stock mutual funds at mid-year 1983. That figure represented an extraordinary net increase of more than 10 million shareowners in two years. Public policies aimed at stimulating saving and investment may very well have led to a further increase over the past two years. Moreover, informal current estimates suggest that an additional 140 million Americans today may own stock indirectly,

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through such assets as pension plans, mutual savings bank accounts and life insurance policies.

If you add to that total of more than 180 million direct and indirect shareowners the additional millions of non-shareowners who work for publicly owned companies, it is clear that the lives and livelihoods of very few Americans remain unaffected by the outcome of any major issue bearing on the ownership of corporations whose shares are publicly owned and publicly traded.

As the nation's largest and best-known public securities market, the New York Stock Exchange is proud of its long history of promoting and safeguarding basic shareholder rights dealing with corporate disclosure and other matters that affect the legitimate interests of anyone who invests in companies whose shares are traded in the NYSE marketplace. The Exchange's pioneering efforts to encourage corporate democracy date back to the late nineteenth century. And corporate practices that investors take for granted today --such as annual and interim reports to shareholders, periodic comparative financial statements and annual shareholder meetings-- all stem from NYSE initiatives that began in the early 1900s. In fact, these standards were part of the Exchange listing agreement before the SEC and other federal regulatory agencies came into existence.

The Exchange also pioneered in the regulation of tender offers long before the Williams Act, and was the first to develop policies relating to defensive tactics that might be used to perpetuate existing managements.

STRINGENT LISTING STANDARDS

To qualify for an NYSE listing, a corporation must satisfy certain basic quantitative standards designed to assure that it measures up to the level of financial quality investors expect of NYSE listed companies, and that its shares are suitable for trading in the open environment of a public exchange auction market. Those standards include, among other things, substantial demonstrated earning power, net tangible assets and market value, and wide distribution of the outstanding shares of the company's common stock.

While these quantitative standards are essential in determining the suitability of a company for listing on the NYSE, the many qualitative standards with which listed companies must comply are even more important to the protection of shareholders' interests.

Every listed company must sign a formal agreement with the Exchange, committing itself to abide by specific additional standards and policies which are designed to ensure that the company keeps its shareholders and potential investors adequately informed and treats them fairly. [A copy of the NYSE Listing Agreement is attached as Exhibit A.]

The Listing Agreement, together with Exchange policies set forth in the NYSE Listed Company Manual, require listed companies to make timely disclosure of significant corporate news and developments, to issue detailed annual and quarterly financial reports, to facilitate participation in corporate affairs by beneficial owners of stock, to assure shareholders the right to

vote on important corporate issues, to comply with proxy solicitation requirements, to have an audit committee comprised solely of independent directors, and so on.

[Selected portions of Section 2 of the NYSE Listed Company Manual ("Disclosure and Reporting Material Information") and Section 3 ("Corporate Responsibility") concerning the Exchange's fundamental qualitative listing standards, are attached as Exhibit B.]

Consistent with its longstanding commitment to encourage high standards of corporate democracy, the Exchange expects listed companies to follow certain practices aimed at maintaining corporate responsibility, integrity and accountability to shareholders. For example:

1. A listed company must convene a meeting of shareholders during each fiscal year.

2. A listed company must solicit proxies for every meeting of shareholders. Failure to do so requires the Exchange to consider delisting the company.

3. Nominee record holders for beneficial owners (such as NYSE member firms that hold securities for customers in "street name") may not give proxies for the shares on significant corporate matters without obtaining voting instructions from the beneficial owners.

4. Since 1926, the Exchange has refused to list a class of non-voting common stock; nor will it list the voting stock of a company that has a class of publicly held non-voting common stock outstanding.

5. The Exchange must consider delisting any company that creates a class of non-voting common stock.

6. Preferred stock of a listed company, voting as a class, must have the right to elect at least two directors upon default of the equivalent of six quarterly dividends.

7. A listed company's Board of Directors may not be divided into more than three classes, and each class must be of approximately equal size and tenure.

8. Domestic listed companies must have an Audit Committee comprised solely of independent directors.

These standards are --by any measure-- the highest required by any securities marketplace. While the American Stock Exchange also maintains qualitative listing standards, the National Association of Securities Dealers (NASD) does not.

[A comparison of fundamental qualitative listing standards currently in effect is attached as Exhibit C.]

Theoretically, state corporation laws would permit shareholders to voluntarily forego the benefits they derive from many of the NYSE's listing standards. But the Exchange, historically, has

required its listed companies to meet standards that exceed the minimum standards required by law.

For example, the Exchange generally objects to irrevocable proxies, through which shareholders agree to vote with management for a specified period -- even if the shareholders agree to them. The Exchange also objects to transactions in which the voting rights of shareholders may be restricted by the use of a voting trust or similar arrangement to which management or the company are a party.

As summarized in Exhibit B, Paras. 310.00 and 312.00, the NYSE's standards exceed the minimums required by law with respect to such matters as:

1. Quorums: The NYSE looks for a majority of the outstanding shares as a quorum for shareholders' meetings. Certain state laws may allow a lesser percentage as a quorum.

2. Matters requiring shareholder approval: NYSE standards require shareholder approval of options, special remuneration plans, changes in corporate control or other significant matters, although not all such matters are required by law to be presented for shareholder approval.

Typically, the stocks of successful publicly owned companies have been traded initially in the over-the-counter market or on a regional stock exchange. As companies have grown, prospered and matured, they have moved to the American Stock Exchange and the NYSE. Each of the markets serves a unique, valuable purpose. One

question that some observers are asking today is: Should all of the markets have the same stringent quantitative and qualitative listing standards as the NYSE?

The NYSE does not believe they should -- or could. Typically, smaller companies need great flexibility in their competitive efforts to raise capital. In many cases, they may require dealer sponsorship to help them gain recognition. Such companies would normally find it impossible to meet the standards NYSE the requires of established and growing companies that have attracted wide national or international interest. It would make no sense to impose the same standards on relatively unknown companies that are in the early stages of their growth. Indeed, it would be futile to try.

Since the NYSE continues to be the industry leader in developing and maintaining high standards of corporate democracy, one of its overriding concerns is to ensure that the market is always geared to help protect the interests of shareholders. At the same time, in the rapidly changing competitive environment of the securities marketplace, competition for corporate listings has become every bit as intense as competition for orders, competition among market-makers and competition among marketplaces. Thus, it is impossible for the NYSE to ignore the fact that other markets have less stringent standards --or no standards at all-- that serve as a competitive attraction and offer companies alternative trading arenas for their stocks.

The market's persistence in undervaluing the assets of many corporations has complicated this situation by creating a climate

in which unnegotiated tender offers have proliferated. The managements of an increasing number of target or potential target companies have expressed concern about the impact of unnegotiated tender offers on the long-term interests of their shareholders, and some of them have taken steps they believe are appropriate to shield their enterprises and their shareholders from unwanted takeovers.

"ONE SHARE, ONE VOTE"

Some corporate managers have reasoned that it is in the legitimate interests of a company --and its shareholders-- for them to retain the ability to manage the company's destiny by securing control over enough votes to reject takeover bids they believe are contrary to the shareholders' best interests. To date, a relatively small number of NYSE listed companies have asked their shareholders to approve changes in voting rights that would, directly or indirectly, give management greater control. In some instances, this has involved creating a second class of common stock having more than one vote per share, with the expectation of enhancing management's control of the company. In several widely publicized cases, shareholders have voted, by large majorities, to approve such proposals. A trend appears to be developing.

Today, even if a company has obtained the approval of its shareholders, the creation of a second class of common stock with unequal voting rights automatically raises the question --under the "one share, one vote" policy-- of whether the Exchange should continue to list the stock. This is the case even though the

company, by every other measure of suitability, remains eligible for listing.

None of the other markets with which the NYSE competes vigorously for corporate listings has any comparable prohibition against companies having two classes of common stock having unequal voting rights. So, NYSE listed companies faced with the possibility of being delisted because they have created a second class of common stock know they will be welcome in those markets.

In the present environment, when a company's management and shareholders face a choice between continuing to be listed on the NYSE --and remaining exposed to hostile or improvident takeover bids-- or taking steps that may cause the Exchange to delist the company, there is a good chance they will choose the latter course.

The Exchange strongly reaffirms its historic commitment to high standards of corporate democracy. But it must also be competitive with other markets. Thus, the issues being addressed by the Subcommittee are national issues, and the Exchange believes that all interested parties must take a very hard look at some very tough questions to which the answers are not at all clear yet.

Many people still find the concept of "one share, one vote" attractive. But is it still meaningful? It used to mean that if you held one share, you were entitled to one vote, and if you held 100 shares, you had 100 votes. Some people believe the concept is obsolete. For example, they ask, is "one share, one vote" still operative if an investor's one share or 100 shares are held by an intermediary like a pension fund or an investment company that

votes them along with millions of other shares that it holds for thousands of other individuals?

Another question: Does the Exchange, in fact, have the right to override a decision made --after full corporate disclosure-- by a substantial majority of a company's owners? If so, when?

And what of the shareholders who have invested in a company precisely because it is listed on the NYSE, which assures them of specific benefits and protections not available to shareholders of non-NYSE stocks? Should the Exchange ignore them in deciding whether to continue to list the company when it has acted in what management sincerely believes to be their best interests?

In the search for realistic answers to those and other difficult questions, the Exchange has been reexamining the "one share, one vote" policy-- and trying to determine whether that policy is still appropriate.

SEEKING A SOLUTION

Last June, recognizing some of the problems that might arise in a rapidly changing environment, the Exchange appointed a special subcommittee to study and prepare recommendations to the Public Policy Committee of the Board of Directors with respect to the present and continued listing standards. That subcommittee comprises three members of the Board's Listed Company Advisory Committee, three members of its Legal Advisory Committee and two members of the Board itself who serve as ex officio members of those advisory committees; it is co-chaired by A. A. Sommer, Jr.,

a partner in the law firm of Morgan, Lewis & Bockius and a former Commissioner of the SEC, and Andrew C. Sigler, Chairman and Chief Executive Officer of Champion International Corporation.

That subcommittee solicited comments from a wide range of Exchange constituents. After analyzing the responses received from some 400 listed companies and other groups and individuals, it reaffirmed the validity of the "one share, one vote" concept. But the subcommittee also recognized that, in today's environment, it might become necessary to find another way of adequately protecting shareholders' rights.

Thus, when the subcommittee presented its report and recommendations to the Public Policy Committee in January, it suggested guidelines under which, if necessary, the NYSE might permit listed companies to issue two classes of common stock having unequal voting rights -- without sacrificing essential shareholder protections.

The subcommittee suggested that the Exchange consider permitting a listed company to issue a second class of common stock with different voting rights -- if the company meets all of the following conditions:

1. The transaction in which shares with different voting rights are to be issued is approved by two-thirds of all shares entitled to vote on the proposition;

2. The proposition is approved by independent directors -- a majority if independent directors comprise a majority of the Board, or all of the independent directors if they comprise less than a majority of the Board;

3. The ratio of voting differential per share is no more than one to ten; and

4. The rights of the holders of the two classes of common stock are substantially the same except for the voting power per share.

The subcommittee also recommended that dual capitalizations be permitted if that is compelled by practice in a foreign-based company's home country.

The subcommittee recommended, further, that the Public Policy Committee consider the following two issues that are not specifically covered by the recommended standards:

. With respect to Standard 4, some members of the subcommittee believed the disparity permissible should be limited to voting for directors, and some believed payment of a larger dividend to holders of the lesser voting shares should be permissible.

. It might be possible for an acquirer to secure control of a corporation by offering a premium price for the higher voting stock and failing to offer the holders of the other type of common stock the opportunity for an equivalent premium.

[The "Initial Report of the Subcommittee on Shareholder Participation and Qualitative Listing Standards -- Dual Class Capitalization," is attached as Exhibit D.]

After considering the subcommittee's report, the Public Policy Committee determined to expose the recommendations and the two

additional issues for further comment by interested constituents before finalizing its own report to the NYSE Board.

The Public Policy Committee received approximately 200 letters of comment, most of them supporting the recommendations of the subcommittee. While the Board has not yet received a formal report from the Public Policy Committee, it did discuss the "one share, one vote" issue at its meeting on June 6th. The Board recognizes that "one share, one vote" has served the nation well over the years, and it continues to support the concept. It also recognizes, however, that if competing markets fail to adopt "one share, one vote," the NYSE will have to find another way to resolve the issue.

So, while no action has been taken on the issue thus far, the Board could seek a resolution as early as its next regular meeting on July 10th.

SUMMARY

An important part of the New York Stock Exchange's reputation as the world's premier securities marketplace rests on its firm commitment to safeguard the legitimate interests of corporate shareholders. The Exchange believes the qualitative listing standards developed and refined over the past half-century or more --including the "one share, one vote" policy-- have been good for its listed companies, good for their shareholders and good for this country. But, realistically, the Exchange also believes that as issues and circumstances change, it must be prepared to reexamine and revise standards and policies which may no longer be relevant.

Over the years, the "one share, one vote" policy has served the market well. Philosophically, the Exchange still believes in it. In an ideal world, most people would probably want it to be retained. But the world is changing very rapidly and the issue transcends the New York Stock Exchange. The changes in the competitive environment that have brought the issue to prominence are national in scope. And the national competitive environment may very well preclude the Exchange from unilaterally retaining "one share, one vote."

In conclusion, it should be stressed that the Exchange is both ready and eager to cooperate fully with the Securities Subcommittee and with the Subcommittee's colleagues in the House of Representatives in the effort to find an equitable solution. Given the realities of today's marketplace, an equitable solution must be found.

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NEW YORK STOCK EXCHANGE, INC.

Exhibit A

LISTING AGREEMENT

Nothing in the following Agreement shall be so construed as to require the Issuer to do any acts in contravention of law or in violation of any rule or regulation of any public authority exercising jurisdiction over the Issuer.

..... (hereinafter called the "Corporation"), in consideration of the listing of the securities covered by this application, hereby agrees with the New York Stock Exchange (hereinafter called the "Exchange"), as follows:

I

1. The Corporation will promptly notify the Exchange of any change in the general character or nature of its business.

2. The Corporation will promptly notify the Exchange of any changes of officers or directors.

3. The Corporation will promptly notify the Exchange in the event that it or any company controlled by it shall dispose of any property or of any stock interest in any of its subsidiary or controlled companies, if such disposal will materially affect the financial position of the Corporation or the nature or extent of its operations.

4. The Corporation will promptly notify the Exchange of any change in, or removal of, collateral deposited under any mortgage or trust indenture, under which securities of the Corporation listed on the Exchange have been issued.

5. The Corporation will:

a. File with the Exchange four copies of all material mailed by the Corporation to its stockholders with respect to any amendment or proposed amendment to its Certificate of Incorporation.

b. File with the Exchange a copy of any amendment to its Certificate of Incorporation, or resolution of Directors in the nature of an amendment, certified by the Secretary of the state of incorporation, as soon as such amendment or resolution shall have been filed in the appropriate state office.

c. File with the Exchange a copy of any amendment to its By-Laws, certified by a duly authorized officer of the Corporation, as soon as such amendment shall have become effective.

6. The Corporation will disclose in its annual report to shareholders, for the year covered by the report: (1) the number of shares of its stock issuable under outstanding options at the beginning of the year; separate totals of changes in the number of shares of its stock under option resulting from issuance, exercise, expiration or cancellation of options; and the number of shares issuable under outstanding options at the close of the year, (2) the number of unoptioned shares available at the beginning and at the close of the year for the granting of options under an option plan, and (3) any changes in the exercise price of outstanding options, through cancellation and reissuance or otherwise, except price changes resulting from the normal operation of anti-dilution provisions of the options.

7. The Corporation will report to the Exchange, within ten days after the close of a fiscal quarter, in the event any previously issued shares of any stock of the Corporation listed on the Exchange have been reacquired or disposed of, directly or indirectly, for the account of the Corporation during such fiscal quarter, such report showing separate totals for acquisitions and dispositions and the number of shares of such stock so held by it at the end of such quarter.

8. The Corporation will promptly notify the Exchange of all facts relating to the purchase, direct or indirect, of any of its securities listed on the Exchange at a price in excess of the market price of such security prevailing on the Exchange at the time of such purchase.

9. The Corporation will not select any of its securities listed on the Exchange for redemption otherwise than by lot or pro rata, and will not set a redemption date earlier than fifteen days after the date corporate action is taken to authorize the redemption.

10. The Corporation will promptly notify the Exchange of any corporate action which will result in the redemption, cancellation or retirement, in whole or in part, of any of its securities listed on the Exchange, and will notify the Exchange as soon as the Corporation has notice of any other action which will result in any such redemption, cancellation or retirement.

11. The Corporation will promptly notify the Exchange of action taken to fix a stockholders' record date, or to close the transfer books, for any purpose, and will take such action at such time as will permit giving the Exchange at least ten days' notice in advance of such record date or closing of the books.

12. In case the securities to be listed are in temporary form, the Corporation agrees to order permanent engraved securities within thirty days after the date of listing.

13. The Corporation will furnish to the Exchange on demand such information concerning the Corporation as the Exchange may reasonably require.

14. The Corporation will not make any change in the form or nature of any of its securities listed on the Exchange, nor in the rights or privileges of the holders thereof, without having given twenty days' prior notice to the Exchange of the proposed change, and having made application for the listing of the securities as changed if the Exchange shall so require.

15. The Corporation will make available to the Exchange, upon request, the names of member firms of the Exchange which are registered owners of stock of the Corporation listed on the Exchange if at any time the need for such stock for loaning purposes on the Exchange should develop, and in addition, if found necessary, will use its best efforts with any known large holders to make reasonable amounts of such stock available for such purposes in accordance with the rules of the Exchange.

16. The Corporation will promptly notify the Exchange of any diminution in the supply of stock available for the market occasioned by deposit of stock under voting trust agreements or other deposit agreements, if knowledge of any such actual or proposed deposits should come to the official attention of the officers or directors of the Corporation.

17. The Corporation will make application to the Exchange for the listing of additional amounts of securities listed on the Exchange sufficiently prior to the issuance thereof to permit action in due course upon such application.

II

1. The Corporation will publish at least once a year and submit to its stockholders at least fifteen days in advance of the annual meeting of such stockholders and not later than three months after the close of the last preceding fiscal year of the Corporation a balance sheet as of the end of such fiscal year, and a surplus and income statement for such fiscal year of the Corporation as a separate corporate entity and of each corporation in which it holds directly or indirectly a majority of the equity stock; or in lieu thereof, eliminating all intercompany transactions, a consolidated balance sheet of the Corporation and its subsidiaries as of the end of its last previous fiscal year, and a consolidated surplus statement and a consolidated income statement of the Corporation and its subsidiaries for such fiscal year. If any such consolidated statement shall exclude corporations a majority of whose equity stock is owned directly or indirectly by the Corporation: (a) the caption of, or a note to, such statement will show the degree of consolidation; (b) the consolidated income account will reflect, either in a footnote or otherwise, the parent company's proportion of the sum of, or difference between, current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of the report; and (c) the consolidated balance sheet will reflect, either in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition as a result of profits, losses and distributions.

Appropriate reserves, in accordance with good accounting practice, will be made against profits arising out of all transactions with unconsolidated subsidiaries in either parent company statements or consolidated statements.

Such statements will reflect the existence of any default in interest, cumulative dividend requirements, sinking fund or redemption fund requirements of the Corporation and of any controlled corporation, whether consolidated or unconsolidated.

2. All financial statements contained in annual reports of the Corporation to its stockholders will be audited by independent public accountants qualified under the laws of some state or country, and will be accompanied by a copy of the certificate made by them with respect to their audit of such statements showing the scope of such audit and the qualifications, if any, with respect thereto.

The Corporation will promptly notify the Exchange if it changes its independent public accountants regularly auditing the books and accounts of the Corporation.

3. All financial statements contained in annual reports of the Corporation to its stockholders shall be in the same form as the corresponding statements contained in the listing application in connection with which this Listing Agreement is made, and shall disclose any substantial items of unusual or non-recurrent nature.

4. The Corporation will publish quarterly statements of earnings on the basis of the same degree of consolidation as in the annual report. Such statements will disclose any substantial items of unusual or non-recurrent nature and will show either net income before and after federal income taxes or net income and the amount of federal income taxes.

5. The Corporation will not make, nor will it permit any subsidiary directly or indirectly controlled by it to make, any substantial charges against capital surplus, without notifying the Exchange. If so requested by the Exchange, the Corporation will submit such charges to stockholders for approval or ratification.

6. The Corporation will not make any substantial change, nor will it permit any subsidiary directly or indirectly controlled by it to make any substantial change, in accounting methods, in policies as to depreciation and depletion or in bases of valuation of inventories or other assets, without notifying the Exchange and disclosing the effect of any such change in its next succeeding interim and annual report to its stockholders.

7. The Corporation will maintain an audit committee in conformity with Exchange requirements (effective 6-30-78).

III

1. The Corporation will maintain in the Borough of Manhattan, City of New York, in accordance with the requirements of the Exchange:

a. An office or agency where the principal of and interest on all bonds of the Corporation listed on the Exchange shall be payable and where any such bonds which are registerable as to principal or interest may be registered.

b. An office or agency where:

(1). All stock of the Corporation listed on the Exchange shall be transferable.

(2). Checks for dividends and other payments with respect to stock listed on the Exchange may be presented for immediate payment.

(3). Scrip issued to holders of a security listed on the Exchange and representing a fractional interest in a security listed on the Exchange will, during the period provided for consolidation thereof, be accepted for such purpose.

(4). A security listed on the Exchange which is convertible will be accepted for conversion.

If at any time the transfer office or agency for a security listed on the Exchange shall be located north of Chambers Street, the Corporation will arrange, at its own cost and expense, that its registrar's office, or some other suitable office satisfactory to the Exchange and south of Chambers Street, will receive and redeliver all securities there tendered for the purpose of transfer.

If the transfer books for a security of the Corporation listed on the Exchange should be closed permanently, the Corporation will continue to split up certificates for such security into certificates of smaller denominations in the same name so long as such security continues to be dealt in on the Exchange.

If checks for dividends or other payments with respect to stock listed on the Exchange are drawn on a bank located outside the City of New York, the Corporation will also make arrangements for payment of such checks at a bank, trust company or other agency located in the Borough of Manhattan, City of New York.

c. A registrar where stock of the Corporation listed on the Exchange shall be registerable. Such registrar shall be a bank or trust company not acting as transfer agent for the same security.

2. The Corporation will not appoint a transfer agent, registrar or fiscal agent of, nor a trustee under a mortgage or other instrument relating to, any security of the Corporation listed on the Exchange without prior notice to the Exchange, and the Corporation will not appoint a registrar for its stock listed on the Exchange unless such registrar, at the time of its appointment becoming effective, is qualified with the Exchange as a registrar for securities listed on the Exchange; nor will the Corporation select an officer or director of the Corporation as a trustee under a mortgage or other instrument relating to a security of the Corporation listed on the Exchange.

3. The Corporation will have on hand at all times a sufficient supply of certificates to meet the demands for transfer. If at any time the stock certificates of the Corporation do not recite the preferences of all classes of its stock, it will furnish to its stockholders, upon request and without charge, a printed copy of preferences of all classes of such stock.

4. The Corporation will publish immediately to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange, and will give prompt notice to the Exchange of any such action; and will afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights; and will issue all such rights or benefits in form approved by the Exchange and will make the same transferable, exercisable, payable and deliverable in the Borough of Manhattan in the City of New York.

5. The Corporation will solicit proxies for all meetings of stockholders.

6. The Corporation will issue new certificates for securities listed on the Exchange replacing lost ones forthwith upon notification of loss and receipt of proper indemnity. In the event of the issuance of any duplicate bond to replace a bond which has been alleged to be lost, stolen or destroyed and the subsequent appearance of the original bond in the hands of an innocent bondholder, either the original or the duplicate bond will be taken up and cancelled and the Corporation will deliver to such holder another bond theretofore issued and outstanding.

7. The Corporation will pay when due any applicable Listing Fees established from time to time by the Exchange.

.....

Date ..... By .....

Exhibit 8

Section 2
Disclosure and Reporting Material Information

201.00 Introduction

A company which lists on the Exchange is expected to be guided by Exchange practices and procedures regarding disclosing and reporting material information as detailed in the Listing Agreement and in this Manual.

The Listing Agreement enumerates the general principles under which listed companies operate. The Exchange urges every listed company to be guided by the current form of agreement in the matters on which it bears even though the specific agreement last executed by it may have been less than comprehensive.

This Manual describes the policies, requirements, practices and procedures of the Exchange in greater detail.

The Exchange's current form of listing agreement generally seeks to achieve the following objectives:

- Ensure timely disclosure of information that may affect security values or influence investment decisions, and in which shareholders, the public and the Exchange have a warrantable interest.
- Ensure frequent, regular and timely publication of financial reports prepared in accordance with generally accepted accounting principles.
- Provide the Exchange with timely information to enable it to efficiently perform its function of maintaining an orderly market for the company's securities, to enable it to maintain necessary records and to allow it the opportunity to make comment as to certain matters before they become established facts.
- Preclude certain business practices not generally considered sound.

Neither the Listing Agreement nor this Manual, can hope to cover every possible situation or transaction. The Exchange recommends that company officials make it a practice to discuss proposed transactions of their company with their Exchange representative on a confidential basis. These prior discussions have often proved helpful and avoided misunderstandings as to interpretations of policy.

The discussion which follows will assist a listed company in making adequate and timely disclosure to its shareholders, the financial community, and the investing public and thus provide the basis for a market for its securities which will be fair to all participants.

202.05 Timely Disclosure of Material News Developments

A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange.

A listed company should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations.

202.06 Procedure for Public Release of Information

(A) Immediate Release Policy

The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press *"For Immediate Release."*

The spirit of the immediate release policy is not considered to be violated on weekends where a "Hold for Sunday or Monday A.M.'s" is used to obtain a broad public release of the news. This procedure facilitates the combination of a press release with a mailing to shareholders.

Annual and quarterly earnings, dividend announcements, mergers, acquisitions, tender offers, stock splits, major management changes, and any substantive items of unusual or non-recurrent nature are examples of news items that should be handled on an immediate release basis. News of major new products, contract awards, expansion plans, and discoveries very often fall into the same category. Unfavorable news should be reported as promptly and candidly as favorable news. Reluctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers management's reputation for integrity. Changes in accounting methods to mask such occurrences can have a similar impact.

It should be a company's primary concern to assure that news will be handled in proper perspective. This necessitates appropriate restraint, good judgment, and careful adherence to the facts. Any projections of financial data, for instance, should be soundly based, appropriately qualified, conservative and factual. Excessive or misleading conservatism should be avoided. Likewise, the repetitive release of essentially the same information is not appropriate.

Few things are more damaging to a company's shareholder relations or to the general public's regard for a company's securities than information improperly withheld. On the other hand, a volume of press releases is not to be used since important items can become confused with trivia.

Premature announcements of new products whose commercial application cannot yet be realistically evaluated should be avoided, as should overly optimistic forecasts, exaggerated claims and unwarranted promises. Should subsequent developments indicate that performance will not match earlier projections, this too should be reported and explained.

Judgment must be exercised as to the timing of a public release on those corporate developments where the immediate release policy is not involved or where disclosure would endanger the company's goals or provide information helpful to a competitor. In these cases, the company should weigh the fairness to both present and potential shareholders who at any given moment may be considering buying or selling the company's stock.

(B) Telephone Alert to the Exchange

When the announcement of news of a material event or a statement dealing with a rumor which calls for immediate release is made shortly before the opening or during market hours (presently 10 A.M. to 4:00 P.M., New York time), it is recommended that the company's Exchange representative be notified by telephone at least ten minutes prior to release of the announcement to the news media. If the Exchange receives such notification in time, it will be in a position to consider whether, in the opinion of the Exchange, trading in the security should be temporarily halted. A delay in trading after the appearance of the news on the Dow Jones or Reuters news wires provides a period of calm for public evaluation of the announcement. The halt also allows customers to revise the terms of limit orders on the specialist's book in view of the news announcement. Even if limit orders are not cancelled or changed during the halt, the fact that trading is halted results in the reopening being considered a new opening, thereby enabling limit orders to participate at the new opening price regardless of the previously entered limit. A longer delay in trading may be necessary if there is an unusual influx of orders. The Exchange attempts to keep such interruptions in the continuous auction market to a minimum. However, where events transpire during market hours, the overall importance of fairness to all those participating in the market demands that these procedures be followed.

(C) Release to Newspapers and News Wire Services

News which ought to be the subject of immediate publicity must be released by the fastest available means. The fastest available means may vary in individual cases and according to the time of day. Ordinarily, this requires a release to the public press by telephone, telegraph, or hand delivery, or some combination of such methods. Transmittal of such a release to the press solely by mail is not considered satisfactory. Similarly, release of such news exclusively to the local press outside of New York City would not be sufficient for adequate and prompt disclosure to the investing public.

To insure adequate coverage, releases requiring immediate publicity should be given to Dow Jones & Company, Inc., and to Reuters Economic Services.

Companies are also encouraged to promptly distribute their releases to Associated Press and United Press International as well as to newspapers in New York City and in cities where the company is headquartered or has plants or other major facilities.

A copy of any such press release should also be sent promptly to the attention of the company's Exchange representative.

The New York City addresses and telephone numbers of these national newswire services are:

Associated Press, 50 Rockefeller Plaza, (212) 621-1500 24 Hours

Dow Jones & Company, Inc., 22 Cortlandt St., (212) 285-5182; after 5:30 P.M., (212) 285-5103

Reuters Economic Services, 1700 Broadway, (212) 581-4250; after 6:30 P.M., (212) 582-4030

United Press International, 220 East 42 Street, (212) 850-8600 24 Hours.

Every news release should include the name and telephone number of a company official who will be available if a newspaper or news wire service desires to confirm or clarify the release.

203.00 Annual and Interim Reporting Requirements

203.01 . Annual Report Requirement

The Exchange requires that companies publish at least once a year and submit to shareholders an annual report containing financial statements of the company and its subsidiaries prepared in conformity with generally accepted accounting principles. The company must distribute its annual report to its shareholders not later than three months after the close of each fiscal year, but at least fifteen days in advance of the annual meeting. When the annual report is mailed to shareholders, four copies should be sent to the Exchange together with advice as to the date of mailing to shareholders.

(A) Method of Publication

The Exchange requires publication of the annual financial statements, as well as their submission to shareholders.

While distribution of the statements to shareholders usually results in their receiving some publicity, to be sure of news coverage, companies should submit the statements, or a news release based thereon, to newspapers of general circulation in large cities and to the national news wire services as described in the "Immediate Release Policy." (See Para. 202.06(A).) In addition, the statements, in the form in which sent to shareholders, should also be sent to the securities statistical services, in whose publications they will remain available for ready public reference.

In the case of a company having only bonds listed on the Exchange, the Exchange expects that the required statements or news releases based thereon be sent to the securities statistical services and requires that copies of the statements be sent to bondholders who request them. It also urges that the statements, or news releases based thereon, be sent to newspapers of general circulation in large cities and to the national news wire services.

(B) Annual Statement to be Independently Audited

The Exchange requires that all financial statements contained in annual reports of the company to its shareholders be audited by independent public accountants who are qualified under the laws of some state or country and are subject to a code of professional ethics of the professional accountancy body in that state or country. The financial statements will be accompanied by a copy of the report issued by the independent public accountants with respect to their examination of such statements.

(C) Form of Financial Statements

The Exchange requires that all financial statements contained in annual reports to shareholders be in the same form as the corresponding statements contained in the company's original listing application or as modified to include the additional disclosure agreed upon by the company and the Exchange. The statements are to be prepared in conformity with generally accepted accounting principles.

(D) General Information in Annual Report

The Exchange recommends that the following information be included in all annual reports:

- Address of principal office.
- Names of directors and officers.
- Identification of directors comprising the Audit Committee and other major committees of the Board of Directors.
- Names and addresses of trustees, transfer agents and registrars.
- Number of employees.
- Number of shareholders.

(E) Occasional Delay in Issuance of Statements

The probability of a delay in the issuance of annual financial statements can ordinarily be foreseen. As soon as it becomes apparent that there may be a delay, the company should advise its Exchange representative of the circumstances and the probable extent of the delay.

If the statements cannot be sent to shareholders at least fifteen days in advance of the annual meeting, it may be necessary for the company to postpone the meeting or to adjourn it without transaction of business to a date which shall be fifteen days after the statements are issued. Whether or not such postponement or adjournment will be necessary can be determined only in the light of the particular circumstances. The matter should be discussed with the Exchange representative as soon as the possibility of the delay becomes apparent.

So far as the three month time limit of the listing agreement is concerned, the Exchange, while ready to extend such time limit on the basis of necessity, does not feel free to do so on the basis of convenience. *For example it cannot consent to a delay in the issuance of the statements just to make possible their simultaneous mailing with the proxy material.*

In the event of a delay in issuance of the audited financial statements, unaudited earnings information, if expected to be substantially in agreement with the final audited figures, should be released to the financial press. (See Para. 202.06(C) for details.) If, that procedure is not feasible, general newspaper publicity should be given to the audited figures as soon as they become available without awaiting completion of the full, formal annual report.

(F) Availability of Form 10-K When Annual Report is Delayed

If distribution of the annual report to shareholders is to be delayed more than two weeks even though the Form 10-K has been filed, the company should release to the financial press copies of the Form 10-K together with a statement advising that the annual report has been delayed and the reason for the delay, specifying the date when the annual report will be mailed and indicating that a copy of the Form 10-K is available to shareholders on request.

203.02. Interim Earnings Reporting Requirement

(A) Time of Publication

No specific time limit for publication of interim earnings statements has been set, but it is assumed that such statements will be published as soon as available.

It is expected that, in this respect, each company will conform at least to the pattern established by the majority of companies in its industry and, where the company has a previous record of publication of interim statements, to the pattern established by that previous record.

(B) Method of Publication

The Exchange requires publication of interim statements as news items in the public press. It is not required that the statements be sent to shareholders although most companies do so. Whether or not the statements are sent to shareholders, to be sure of adequate coverage the statements should be released to newspapers and to the national news wire services, as described in the "Immediate Release Policy." (See Para. 202.06(A).) In addition, they should be sent to the securities statistical services.

Two copies of each interim earnings statement, in the form released for publication, should be filed with the Exchange. If the company sends interim statements to its shareholders, two copies should be filed with the Exchange.

(C) Form of Interim Financials

The listing agreement merely requires publication (quarterly or semi-annually, as the case may be), of a statement of earnings; it does not require that such statement be sent to shareholders. Interim earnings statements shall be on the same basis of consolidation as the company's annual financial statements and shall disclose, as a minimum, any substantial items of unusual or non-recurrent nature and either net income before and after federal income taxes or net income and the amount of federal taxes. Additional information, and particularly sales data, will, of course, be useful to shareholders.

Such statements may cover each quarter individually or may cover, cumulatively, the elapsed quarters of the current fiscal year; i.e., the statement for the first quarter covering three months, that for the second quarter covering six months and that for the third quarter covering nine months. Publication, each quarter, of a statement covering the preceding twelve months is not generally acceptable, although such moving-year statement may be included as a supplement to the individual or cumulative quarterly statement.

It is recommended that each interim statement include like figures of the same period of the previous year, to afford a basis for comparison. This device may be particularly useful in a case where there is a seasonal cycle in the business.

(D) Exceptions to Policy

Exceptions have been made to this requirement only in cases where conditions peculiar to the type of company, or to the particular company itself, would make quarterly statements impracticable or misleading, as in the case of companies dependent upon long-term contracts, or companies dependent upon the growth and sale of a crop in an annual cycle, or companies operating under conditions which make publication of quarterly statements virtually impossible.

In a case where the Exchange is convinced that quarterly statements are impracticable, or misleading, it may require an agreement to publish semi-annual statements of earnings, or interim statements reporting certain operating statistics which will strive to indicate the trend of the company's business during the period between annual reports.

While no fourth quarter statement is required, items of unusual or non-recurrent nature occurring in the fourth quarter should be reflected separately in the full year earnings release.

Section 3 Corporate Responsibility

301.00 Introduction

Investors expect that if a company's shares are listed on the New York Stock Exchange, the company has complied with specified financial standards and disclosure policies developed and administered by the Exchange. In addition, consistent with the Exchange's long-standing commitment to encourage high standards of corporate democracy, every listed company is expected to follow certain practices aimed at maintaining appropriate standards of corporate responsibility, integrity and accountability to shareholders.

This section describes the Exchange's policies and requirements with respect to independent audit committees, ownership interests of corporate directors and officers, shareholders' voting rights, and other matters affecting shareholders' ownership interests and the maintenance of fair and orderly markets in listed securities.

302.00 Annual Meetings

Listed companies are required to hold an annual shareholders' meeting during each fiscal year.

303.00 Audit Committee

Exchange Policy—

Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978 and maintain thereafter an Audit Committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for Audit Committee membership.

A director who was formerly an officer of the company or any of its subsidiaries may qualify for membership even though he may be receiving pension or deferred compensation payments from the company if, in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee. However, a majority of the Audit Committee shall be directors who were not formerly officers of the company or any of its subsidiaries.

Supplementary Material—
In order to deal with complex relationships that may arise, the following guidelines are provided to assist the Board of Directors to observe the spirit of the policy in selecting members of the Audit Committee.

A director who has been or is a partner, officer or director of an organization that has customary commercial, industrial, banking or underwriting relationships with the company which are carried on in the ordinary course of business on an arms-length basis may qualify for membership unless, in the opinion of the Board of Directors, such director is not independent of management or the relationship would interfere with the exercise of independent judgment as a committee member.

A director who, in addition to fulfilling the customary director's role, also provides additional services directly for the Board of Directors and is separately compensated therefor, would nonetheless qualify for membership on the Audit Committee. However, a director who, in addition to his director's role, also acts on a regular basis as an individual or representative of an organization serving as a professional advisor, legal counsel or consultant to management, would not qualify if, in the opinion of the Board of Directors, such relationship is material to the company, the organization represented or the director.

A director who represents or is a close relative of a person who would not qualify as a member of the Audit Committee in the light of the policy would likewise not qualify for the committee. However, if the director is a close relative of an employee who is not an executive officer or if there are valid countervailing reasons, the Board of Directors' decision as to eligibility shall govern.

While Rule 405 under the Securities Act of 1933 may be helpful to the Board of Directors in determining whether a particular director is an affiliate or a close relative for purposes of this policy, it is not intended to be so technically applied as to go beyond the spirit of this policy.

304.00 Classified Boards of Directors

The Exchange expects that Boards of Directors will be elected by all of the shareholders entitled to vote as a class except where special representation is required by the default provisions of a class or classes of preferred stock.

The Exchange will refuse to authorize listing where the Board of Directors is divided into more than three classes. Where classes are provided, they should be of approximately equal size and tenure and directors' terms of office should not exceed three years.

310.00 Quorums

(A) Common Stock

The Exchange is of the opinion that the quorum required for any meeting of the holders of common stock should be sufficiently high to insure a representative vote. In authorizing listing (whether original listing or listing of additional securities), the Exchange gives careful consideration to provisions fixing any proportion less than a majority of the outstanding shares as the quorum for shareholders' meetings. In general, the Exchange has not objected to reasonably lesser quorum requirements in cases where the companies have agreed to make general proxy solicitations for future meetings of shareholders.

(B) Preferred Stock

While a representative vote of shareholders is desirable, the fixing of a high quorum requirement for a preferred stock may tend to make right of election of directors in case of defaulted dividend payments ineffective, due to inability of the class to attain the required quorum. The Exchange, therefore, considers if preferable that no quorum requirement be fixed in respect of the right of a preferred stock, voting as a class, to elect directors when dividends are in default. Where a quorum requirement is fixed in respect of such right, the Exchange will object if such requirement calls for a higher percentage of the outstanding shares of the class to constitute a quorum than is required to constitute a quorum of the common stock for election of directors.

311.00 Redemption of Listed Securities, Tender Offers

311.01 Publicity and Notice to the Exchange of Redemption

A company's listing agreement with the Exchange requires that prompt publicity be given and prompt notice be sent to the Exchange of corporate action (or any action of which the company has knowledge) which will result in, or which looks toward, either the partial or full call for redemption of a listed security.

Full responsibility for the release of such news is placed upon the company. The company should coordinate with its trustee or agent so that the company may be assured such obligation has been fulfilled.

The company shall follow the timely disclosure/telephone alert procedures of the Exchange which is found in Paras. 202.05 and 202.06(B).

The news release and notice to the Exchange shall be made as soon as possible after taking corporate action which will lead to, or which looks toward, partial or full redemption, or as soon as possible after the company acquires knowledge of any such action taken by others, and should be made by the fastest available means. Notice to the Exchange shall be received by the Exchange at least fifteen days in advance of the redemption date. Attention is called to the fact that the Exchange must receive at least ten days' notice of any date for the taking of a record of shareholders or closing of transfer books.

In the case of a total redemption, immediate notice to the Exchange has the additional importance of enabling the Exchange to give prompt notice of the redemption over its ticker system as a precaution against the investing public dealing in the security without knowledge of the impending redemption. It also permits the Exchange promptly to issue a ruling as to the basis of further dealings in the security, attach a special designation to its ticker symbol, and take other steps for continuance of an orderly market in the security.

Information to be Included in Publicity and Notice to the Exchange

The press release and notice to the Exchange should indicate:

- The redemption date, redemption price and any dividend or interest to be paid upon redemption.
- If provision is to be made for payments of redemption funds to holders of the redeemed security prior to the redemption date, when such funds will be available to holders.
- The name and address of the redemption or paying agent.
- If a redeemed security is convertible, the name and address of the conversion agent, the rate of conversion and the date and time when the conversion period will expire. If there will be a period during which conversions cannot be effected, indicate the dates beginning and ending that period.
- Where the securities to be reedemed are convertible, if any dividend declared (or accrued) on or before the date of the redemption remains unpaid on the class of security issuable upon conversion of the securities to be redeemed, whether or not shares issued upon such conversion will be entitled to receive such dividend.
- If, in the case of a partial redemption, a record date is to be employed or if the transfer books are to be closed for the purpose of a determination of the shares to be redeemed, the date of record or dates of closing and re-opening of the books.
- In the case of a partial redemption, the total number (or maximum number) of shares to be redeemed.
- In the case of a partial redemption of bonds, the total principal amount of bonds to be redeemed, and the dollar amount of interest which will be paid on the redeemed securities upon redemption.

The notice to the Exchange should also indicate:

- The method, in the case of a partial redemption, by which shares to be

redeemed will be selected (pro rata, by lot, etc.).

▶Whether, in the case of a partial redemption, the transfer books will be closed permanently with respect to the shares to be redeemed, when such closing will take place or whether stamped certificates will be issued upon transfer of the shares to be redeemed.

The notice to the Exchange must be in writing, and if possible delivered by hand to the Exchange. If immediate hand delivery cannot be made, notice to the Exchange of the redemption action should be given by telephone no later than simultaneously with the release of the information to the newspapers and news wire services and confirmed promptly by TWX, telegram, or telecopier.

As to any of the above-listed information not known or determined at the time of publicity or when initial notice is given to the Exchange, similar publicity or notice shall be given immediately when such information becomes known or determined.

As soon as available, the Exchange should also be provided:

▶Certified copy of any resolutions of the Board of Directors of the company in respect of the redemption.

▶Two copies of any notice or other material sent to security holders, with regard to the redemption.

▶Notification of the deposit of funds for payment of the redeemed securities.

(A) Record Date; Closing of Transfer Books; Advance Notice

The Exchange requires prompt notice of action taken to fix a record date or to close the transfer books for the purpose of selection of the securities to be redeemed or for any other purpose in connection with a redemption.

(B) Place of Redemption

The Exchange requires the maintenance of an agency in the Borough of Manhattan, City of New York, where securities called for redemption may be presented for payment.

If funds for redemption are deposited in a bank located in a city other than New York and the letter of transmittal provides for the redemption at such bank, arrangements also should be made for the acceptance of called securities and payment of the redemption price at an agency in New York City. Such agency may be the New York correspondent of such bank.

(C) Notice of Redeemed Certificate Numbers

If securities to be redeemed are to be determined by drawing of certificates, the Exchange requests that it be sent as promptly as possible after the drawing 700 printed copies of a notice, prepared by the company or its agent, stating all significant facts and listing the numbers of certificates drawn for redemption, and the number of shares to be redeemed in respect of each certificate (if the whole certificate is not being redeemed). The copies should be hand delivered to the Exchange, if feasible. The Exchange will thereupon distribute the notices to member organizations. This procedure is essential, as certificates that are drawn for redemption cease to be a good delivery for settlement of contracts made in the regular way on the Exchange after the date the serial numbers are known or become available, by publication or otherwise.

311.02 Trading in Securities Called for Redemption

(A) Full Call

When a non-convertible listed security is redeemed, trading is suspended as soon as the redemption funds become available to holders of the security. In the case of a convertible security where the market price is at or close to the conversion price, suspension may be delayed until such time as conversion ceases to be active, the conversion privilege expires or the outstanding amount of the listed security has been reduced to a level where continued trading would be inadvisable.

(B) Partial Call

When only part of a non-convertible listed security is redeemed, the amount authorized to be listed is reduced by the amount redeemed as soon as the redemption funds

become available to holders of the redeemed security. When securities are convertible, the reduction in the amount authorized to be listed is deferred until conversions occur, or until expiration of the right of conversion.

Under the rules of the Exchange, securities called for redemption are not deliverable in settlement of contracts on and after the date the serial numbers are known or become available by publication or otherwise, except in respect of transactions in called securities dealt in specifically as such. If the amount called for redemption is substantial or if the transfer books for the called portion of the security are not to be permanently closed until the date of redemption, the Exchange will trade the called portion separately if it considers such action to be in the public interest. When this is done, trading continues until the redemption or, in the case of a convertible security, until the expiration of conversion rights if that is earlier than the redemption. The listed company is not required to take any action in regard to the separate trading on the Exchange of the called portion of the security.

311.03 Tender Offers

The Exchange believes it is important that all shareholders of a company be given an opportunity to participate on equal terms in any tender offer made which may affect the rights or benefits of such shareholders.

This objective has been implemented by the company's listing agreement with the Exchange. As an example, a company agrees that it will not select any of its securities listed on the Exchange for redemption otherwise than pro rata or by lot.

The same considerations apply when a company invites its shareholders or shareholders of another company to tender their shares for purchase even though such tender offers are not covered by a listing agreement. It is important, therefore, that all shareholders be given an equal opportunity to participate in such offers.

While it is desirable that a period of about 30 days be used, a tender offer should remain open for a minimum of 10 days, so that all shareholders, even though they may live at a distance, will have ample opportunity to learn of the tender offer and tender their shares. Where the minimum period is used, notices should be sent by air mail to distant shareholders and provision made for telegraphic acceptance through a member organization or bank, similar to a rights offering.

If only a specified number of shares are to be purchased, the offer should provide that tenders will be accepted on a pro rata basis if more shares are tendered than are to be purchased. An offer on any other basis, such as a "first-come first-served" basis, is objectionable, as shareholders residing near the place of the tender offer may immediately supply all the stock that is to be purchased, with the result that shareholders living at a distance would have no opportunity to take advantage of the tender offer. After a minimum period of 10 days for the acceptance of shares on a pro rata basis, there is no objection to receiving shares thereafter on a "first-come first-served" basis.

Normally a tender offer is not limited to shareholders of record on any given date. The reason for this is that some holders may not be holders of record on a given date, either because of the use of their stock for lending purposes or due to the fact that stock had not been transferred to their names. Under such circumstances, shareholders who wish to accept an offer would be deprived of their right to do so. However, if a record date is essential to a company's program, it should not be earlier than 10 days after announcement of the tender offer, in order to give all shareholders an opportunity to transfer and thereby to protect their interests.

The company may accept the total amount of shares of a shareholder if his complete holdings are 99 shares or less before accepting shares on a pro rata basis. Such feature must be expressed within the offering circular.

The company must immediately advise the Exchange of any over-tendered offerings. In such cases the Exchange may have to create special trading procedures.

Should an out-of-town depositary be utilized, a depositary in New York should also be provided, or at least a forwarding agent or "drop" in New York.

Occasionally, companies may feel it practicable to make a tender offer limited only to shareholders of less than a hundred shares. The usual reasons given are the high administrative costs involved in handling small shareholder accounts and the difficulty of small shareholders to find a broker to handle a stock sale. Although a tender offer of this type is discriminatory in nature and normally would violate Exchange policy, exception might be made in special circumstances. The Exchange should be consulted ahead of time to discuss the number of odd-lot holders the company has, which shareholders would receive the tender offer, the proposed premium, a record date, and the method by which the tender offer will be made.

The offering material should be delivered to the Exchange no later than the distribution date to shareholders.

Before a tender offer is made with terms at variance with the principles of this statement, they should be discussed with the Exchange.

312.00 Shareholder Approval Policy

Shareholders' interest and participation in corporate affairs has greatly increased. Management has responded by providing more extensive and frequent reports on matters of interest to investors. In addition, an increasing number of important corporate decisions are being referred to shareholders for their approval. This is especially true of transactions involving the issuance of additional securities.

Companies are urged to discuss questions relating to this subject with their Exchange representative sufficiently in advance of filing a listing application to allow time for the calling of a shareholders meeting and the solicitation of proxies where shareholder approval may be involved. All relevant factors will be taken into consideration in applying the above policy and the Exchange will advise whether or not shareholder approval will be required in a particular case.

Good business practice is frequently the controlling factor in the determination of management to submit a matter to shareholders for approval even though neither the law nor the company's charter makes such approval necessary. The Exchange encourages this growth in corporate democracy.

Shareholder approval is a prerequisite to listing securities to be issued for or in connection with the following:

1. Options granted to or special remuneration plans for directors, officers or key employees.
2. Actions resulting in a change in the control of a company.
3. The acquisition*, direct or indirect, of a business, a company, tangible or intangible assets or property or securities representing any such interests:
   (a) From a director, officer or substantial security holder of the company (including its subsidiaries and affiliates) or from any company or party in which one of such persons has a direct or indirect interest;
   (b) Where the present or potential issuance of common stock or securities convertible into common stock could result in an increase in outstanding** common shares of 18½% or more; or
   (c) Where the present or potential issuance of common stock and any other consideration has a combined fair value of 18½% or more of the market value of the outstanding** common shares and the present or potential issuance of common stock has a fair market value in excess of 5% of the market value of the outstanding common shares.

Shareholder approval would also be a prerequisite to listing warrants where the aggregate of common shares purchasable upon exercise of those warrants exceeds 18½% of the outstanding common shares at the time of issuance of such warrants.

*A series of closely related transactions may be regarded as one transaction for the purpose of this policy.

** Only those shares actually issued and outstanding excluding treasury shares or shares held by a subsidiary) are to be used in making this calculation. Unissued shares reserved for issuance upon conversion of securities, exercise of options or warrants for any other purpose will not be regarded as outstanding.

(A) Listing Authorization Subject to Shareholder Action

Under certain circumstances, the Exchange will act upon a listing application relating to a matter on which shareholders are to take action prior to the time such action is taken. In such cases it is the practice of the Exchange to make its listing authorization subject to the action subsequently taken by shareholders on such matter, so that such authorization does not become final until the shareholders have acted. Where this procedure is followed the application is not released for public distribution, nor is public announcement of the Exchange's action made, until advice of shareholder approval is received. By this procedure, early admission of the securities involved and, perhaps, early consummation of the transaction in which they are to be issued may be expedited, while any possible influence which the prior announcement of the Exchange's listing authorization might have upon the outcome of shareholders' action is avoided.

(B) Vote Required, Definition

Where shareholder approval is a prerequisite to the listing of any additional or new securities of a listed company, the minimum vote which will constitute shareholder approval for listing purposes is defined as "approval by a majority of votes cast on a proposal in a proxy bearing on the particular matter, provided that the total vote cast on the proposal represents over 50% in interest of all securities entitled to vote on the proposal."

(C) Results of Shareholder Vote Considered

Where issuance of the securities to which a listing application relates is to be, or has been, acted upon by shareholders, it is the policy of the Exchange to consider the results of the shareholder vote before giving final listing authorization. This policy applies both to cases in which the shareholder's action is in direct relation to such issuance and to cases where their action does not relate directly to such issuance but, instead, relates to a matter implementing such issuance. In reporting shareholder action to the Exchange, the number of votes cast in favor of and against the related proposal should be given.

313.00 Voting Rights

(A) Non-Voting Common Stock

Since 1926, the Exchange has refused to authorize the listing of non-voting Stock, however designated, which by its terms is in effect a common stock. This restriction would not apply to the listing of non-voting common stock of quasi-governmental corporations where, by reason of legislative or judicial mandate, the issuance of voting stock to the public is restricted. The Exchange will also refuse to list the common voting stock of a company which also has outstanding a non-voting stock however designated which by its terms is in effect a common stock. In line with the above, the Exchange normally will refuse to list voting trust certificates. Exception has been made in the case of voting trusts established pursuant to reorganization proceedings under court direction.

(B) Restrictions on Voting Rights Through Voting Trusts or Similar Arrangements

The Exchange would object to transactions where the voting rights of shareholders have been restricted by the use of a voting trust, irrevocable proxy, or any similar arrangement to which the company or any of its directors or officers is a party, either directly or indirectly. The Exchange would neither approve the original listing of a company where the above mentioned provisions exist nor authorize the listing of additional shares of such a listed company.

(C) Unusual Voting Provisions

Creation of a class of stock which has unusual voting provisions which tend to nullify or restrict voting, or which subject the common stock to the unusual voting provisions of that class of stock, could affect the continued listing status of the company. A situation in which one class of stock has the right to veto the actions of the common stock is an example. The

Exchange may refuse to list a class of stock which has unusual voting provisions.

(D) Proportionate Voting Power

In cases where voting power is divided between the common stock and one or more other classes of stock under normal conditions (as distinguished from conditions under which such other class or classes temporarily acquire voting power as a result of dividend default or some other similar occurrence), the Exchange, when considering the listing of the common stock, will take into account the relationship between the proportion of the total voting power represented by such other class or classes and their relative equities in the company.

The circumstances under which different classes of stock are issued, their priorities and preferences, and their equity interests are so varied that the Exchange has not found it feasible to fix standards as to what constitutes the appropriate apportionment of voting power as between different classes of stocks. Therefore, each case must be considered individually. However, the Exchange is of the view that any allocation of voting power under normal conditions to classes of stock other than common stock should be in reasonable relationship to the equity interests of such classes. If the voting power of such other classes is in excess of such reasonable relationship, the Exchange may refuse to authorize listing of the common stock.

(E) Preferred Stock, Minimum Voting Rights Required

The Exchange recommends that preferred stock should have the following minimum voting and redemption rights even if the preferred stock is not listed.

Class Vote for Directors Upon Default—

- Preferred stock, voting as a class, should have the right to elect a minimum of two directors upon default of the equivalent of six quarterly dividends.
- The right to elect directors should accrue regardless of whether defaulted dividends occurred in consecutive periods.
- The right to elect directors should remain in effect until cumulative dividends have been paid in full or until non-cumulative dividends have been paid regularly for at least a year.

Exhibit C

COMPARISON OF FUNDAMENTAL QUALITATIVE LISTING STANDARDS
IMPOSED BY NEW YORK STOCK EXCHANGE, AMERICAN STOCK EXCHANGE
AND NATIONAL ASSOCIATION OF SECURITIES DEALERS

	NYSE	AMEX	NASD
VOTING RIGHTS			
List non-voting common stock *[Par. 313.00(A)]	No	No	NASD
List voting stock of a company with a class of non-voting stock outstanding *[Par. 313.00(A)]	No	Yes	
Require minimum voting rights for preferred stock in event of dividend default *[Par. 313.00(E)]	Yes	Yes	HAS
List common stock which has the right to elect only a minority of Board of Directors	No	Yes (1)	NO
DUAL CLASS CAPITALIZATION			
Require proportionate voting between classes of stock *[Par. 313.00(D)]	Yes	Partial (1)	SPECIFIC
AUDIT COMMITTEE			
Requires audit committee, comprised solely of independent directors *[Par. 303.00]	Yes	No (2)	RULES
CLASSIFIED BOARDS			OR
May not exceed three classes of approximately equal size and tenure *[Par. 304.00]	Yes	No	REQUIREMENTS
QUORUM REQUIREMENT			IN
Generally bars less than a majority of outstanding shares serving as a quorum *[Par. 310.00]	Yes	Recommends minimum 33 1/3%	THESE
ANNUAL MEETINGS MUST BE HELD *[Par. 302.00]	Yes	Yes	AREAS.

Exhibit C

COMPARISON OF FUNDAMENTAL QUALITATIVE LISTING STANDARDS
IMPOSED BY NEW YORK STOCK EXCHANGE, AMERICAN STOCK EXCHANGE
AND NATIONAL ASSOCIATION OF SECURITIES DEALERS

	NYSE	AMEX	NASD
PROXY SOLICITATION			
Requires that Proxies be solicited for every meeting of shareholders [Par. 802.00]	Yes	Yes	NASD
Requires beneficial owners to vote on significant corporate matters [Par. 402.08(B)]	Yes	Yes	HAS
SHAREHOLDER APPROVAL REQUIRED			
Options or special remuneration plans for directors, officers, key employees *[Par. 312.00, Subpar. 1.]	Yes	Yes	NO
Actions resulting in a change of control *[Par. 312.00, Subpar. 2.]	Yes	No	
Acquisitions: - From a director, officer, or substantial security holder... *[Par. 312.00, Subpar. 3(a)]	Yes	Yes	SPECIFIC
- Where present or potential issuance of common stock or equivalent increases outstanding common by more than a certain percentage of the outstanding common shares *[Par. 312.00, Subpar. 3(b)]	18 1/2%	20%	RULES
- Where present or potential issuance of common stock and any other consideration has a combined fair market value more than a certain percentage of the outstanding shares *[Par. 312.00, Subpar. 3(c)]	18 1/2%	20%	OR
TENDER OFFER POLICY			
Equal opportunity to participate *[Par. 311.03]	Yes	Comply with law	REQUIREMENTS.

Exhibit C

COMPARISON OF FUNDAMENTAL QUALITATIVE LISTING STANDARDS

IMPOSED BY NEW YORK STOCK EXCHANGE, AMERICAN STOCK EXCHANGE

AND NATIONAL ASSOCIATION OF SECURITIES DEALERS

	NYSE	AMEX	NASD
TENDER OFFER POLICY (Cont.'d)			
Pro-rata requirement on over-tender *[Par. 311.03]	Yes	Comply with law	HAS NO SPECIFIC
TIMELY DISCLOSURE, FINANCIAL DISCLOSURE			
Requires "immediate" release of corporate news *[Par. 202.05]	Yes	Yes	RULES OR
Requires submission of annual report to shareholders *[Par 203.01]	3 mos. after year end	4 mos. after year end	REQUIREMENTS
Requires publication of interim and annual earnings *[Par. 203.02 and 203.01]	Yes	Yes	IN THIS AREA

Notes:
[Par. ___.___] reference is to the corresponding paragraph of the NYSE Listed Company Manual.

*See Exhibit B for reprint of paragraph from NYSE Listed Company Manual.

1) AMEX requires that any junior stock issue must have a right to elect at least 25% of the directors and that the vote differential may not be more than 10:1.
(2) AMEX recommends, does not require.

NYSE
New York
Stock Exchange

Exhibit D

Initial Report of the Subcommittee on Shareholder Participation and Qualitative Listing Standards

Dual Class Capitalization

Presented to the
Public Policy Committee
of the
Board of Directors of the
New York Stock Exchange, Inc.

January 3, 1985

In June 1984 Chairman John Phelan, Jr., appointed this Subcommittee consisting of three members of the Listed Company Advisory Committee and three members of the Legal Advisory Committee and two members of the Exchange Board who are liaison to the two Advisory Committees. The mandate to the Subcommittee was to make recommendations to the Public Policy Committee of the Board of the Exchange with respect to the continued relevance and appropriateness of the Exchange's present listing standards relating to shareholder participation in corporate affairs, which include a number of listing standards that are not quantitative (the requirement with respect to the number of shares in the "float" is an example of a quantitative standard) in nature. These standards include those which bar a listed company from having authorized two classes of common stock with disparate voting rights, prohibitions against certain issuances of large amounts of stock in connection with acquisitions without shareholder vote, prohibitions against certain kinds of voting arrangements, such as according to a party other than the shareholder the right to vote shares, and the requirement that changes in control sought to be accomplished by management be approved by shareholders.

To assist us in our deliberations and ultimate development of recommendations to the Public Policy Committee, the Subcommittee surveyed the reactions of six key Exchange constituent groups — listed companies, member firms, major institutional investors, the legal profession, academia, and state securities administrators — to the following inquiries:

1. Should the NYSE continue present shareholder participation requirements?

2. Should the NYSE modify its policies to permit two classes of stock if approved by shareholders?

3. Should approval by independent directors be an acceptable alternative to present restrictions?

4. Should the NYSE urge the SEC or Congress to require other markets to adopt shareholder participation measures similar to the NYSE's?

5. Should the NYSE impose restrictions on "greenmail," "golden parachutes," etc.?

6. Would the possible loss of listings affect the responses to the foregoing inquiries?

More than 3,200 constituents received the survey questionnaire (a copy is attached as Exhibit A). A total of 425 submitted responses to one or more of the survey questions — an overall participation rate of 13%. Not surprisingly, listed companies had the highest response rate — 20%, or 309 responses. The lowest response rate — 4% — came from member firms.

A statistical analysis of responses is attached as Exhibit B. However, some general observations seem pertinent.

A majority of the respondents — 58% — agreed that the Exchange should not continue its present shareholder participation requirements. A larger majority — 79% — urged the Exchange to modify current policy to permit two classes of stock if a company's shareholders approve such action. The commentators were almost equally divided on whether approval by independent directors should be required for adoption of such a proposal; some suggested that approval by shareholders and by independent directors should be required.

Listed companies — the largest group of respondents — strongly agreed that the Exchange should permit two classes of stock, reduce shareholder participation requirements, not seek uniform requirements for all markets, and not play any regulatory role with respect to such practices as "greenmail" and "golden parachutes."

The second largest numerical group of respondents — members of the legal profession — generally shared those views, with somewhat less unanimity.

Where other respondents disagreed, their relatively small numbers did not substantially alter the consensus.

The Subcommittee members were particularly impressed by the large number of very thoughtful comments that accompanied most of the completed survey questionnaires. Clearly these constituents share the Exchange's concerns and devoted great care to preparing responses which have been extremely helpful to the Subcommittee and which are reflected in our recommendations.

The Subcommittee believes a re-examination of the listing standards related to shareholder participation (as well as other listing standards) is appropriate. The first edition of the Listed Company Manual was not published until 1953, hence, in some instances when the standards originated and the circumstances out of which they grew are unclear. Since adoption of these standards, the investing and regulatory worlds have undergone considerable change.

Under state law there are and have been virtually no requirements for management's reporting periodically to shareholders or rules governing the manner in which proxies are solicited; prior to 1933 virtually the only reporting requirements were those imposed by the New York Stock Exchange, which included a requirement that each listed company's financial statements be audited annually.

However, since 1933 the Securities and Exchange Commission has elaborated an extensive and sophisticated system of corporate disclosure which vastly exceeds in scope the disclosure requirements still in the Exchange's listing requirements, especially with respect to proxy solicitations. At the time when the Exchange's requirements appear to have first been adopted, various devices were used to make nugatory actual shareholder participation in corporate affairs. Proxies, when they were sought, were usually solicited with little, if any, information concerning the proposals to be voted upon furnished to shareholders. In 1944, the SEC in its Annual Report remarked,

> Too frequently the owner of the shares was given no assurance that the items mentioned in the notice were the only ones which the management expected to bring up for consideration at the meeting. The stockholder was merely invited to sign his name and return his proxy without being furnished the information essential to the intelligent exercise of his right of franchise.

Now, of course, when management proposes, for instance, a recapitalization, the shareholders are furnished with extensive information concerning the intentions of management, the impact on control of the company, and the interest of management in the proposal.

In recent times independent directors and independent audit committees (as well as other committees of the board composed either in whole or in majority of independent directors) have been perceived increasingly as safeguarding shareholder interests, and many commentators expect their importance in that role to grow considerably. The Exchange has recognized this trend by requiring that all listed companies have at least two independent directors and an audit committee comprised entirely of such directors.

At the time when these standards were adopted, hostile tender offers were virtually unknown. At that time the conventional means by which one company acquired another was through statutory merger or an acquisition of substantially all assets; usually in both cases the consent not only of shareholders voting as a body but the board of directors as well of the acquired company was necessary to effectuate the transaction. Tender offers today are generally accomplished without the acquiescence of the board of directors or a formal vote by the shareholders acting as a body. The onset of tender offers has caused a wide-ranging re-examination of many accepted legal doctrines, such as the business judgment rule, and has generated calls for the Securities and Exchange Commission and the Congress to undertake an examination of tender offer practices and the regulation of them.

Additionally, the competition among market places for the trading of securities has been intensified. The commencement and expansion of the NASDAQ System and the marketing of the over-the-counter market by the National Association of Securities Dealers' so-called NASDAQ "National Market System" is changing the role of the over-the-counter dealer market.

The over-the-counter market has been, and continues to be to a large extent, the market for issuers which are not eligible for listing on the New York Stock Exchange. SEC Rule 19c-3, which allows the continuance of over-the-counter trading in issues listed on an exchange after April 26, 1979, has contributed to the blurring of the traditional distinction between the over-the-counter dealer market and the Exchange agency-auction trading market.

It is generally agreed that competition for orders is good when such competition relates to the efficiency of executions, the prompt availability of information concerning trading activity, extent and style of dealer involvement, rules governing responsibility of participants in the market, and the like. However, we do not believe that differences in standards relating to corporate governance and shareholder participation benefit investors and shareholders. Clearly, there should be no "race for the bottom" as marketplaces compete for listings and trading volume.

Finally, and this factor should not be underestimated, there has occurred a dramatic change in the shareholder mix with respect particularly to New York Stock Exchange listed companies. While nearly 42.4 million Americans continue to be shareholders, it is estimated that about half the securities of some New York Stock Exchange listed companies are held by institutions. Some commentators predict that this proportion will increase over the years. The present listing standards reflect a time when listed securities were held overwhelmingly by individual shareholders who received little information and had little sophistication concerning issues submitted to them for vote. Institutional investors have different characteristics, investment practices and relationships to the companies in which they invest and they are generally knowledgeable about matters submitted to shareholders for vote. Their increasing presence as holders of Exchange-listed securities and their increasing sensitivity to issues such as those involving shareholder participation provide an additional measure of assurance that such participation will be meaningful.

Against this history and backdrop, many managements have become increasingly concerned with the possibility of an unnegotiated tender offer for the stock of their companies. This concern often stems from a genuine belief that the disruption and turmoil attending such an offer is harmful to the interests of shareholders, customers, suppliers, communities and others as well, and that it is desirable from the standpoint of those constituencies that the company remain independent, or in the alternative, be acquired in a negotiated transaction. To increase their ability to thwart such a hostile offer, many companies have proposed to their shareholders recapitalizations whereby two classes of common stock are created, one class having significantly greater voting power per share than the other. The terms of the stock typically include provisions that will eventually result in the concentration of the higher voting stock in the hands of management, thereby making virtually impossible any acquisition of the company other than in a transaction satisfactory to management.

These provisions must be submitted to shareholders and in a number of recent cases the shareholders have approved them; in the case of one company, the vote of non-management related shares was three to one in favor, including a significant affirmative vote by institutional holders. Thus, regardless of any detriment which may accrue to non-management shareholders as a consequence of such arrangements, they frequently appear to be ready to accept the arguments and recommendations of management in their voting. This gives rise to the highly relevant inquiry whether in such a situation, when shareholders are provided with extensive and meticulously regulated information concerning issues submitted to them and then vote for such recapitalizations, the Exchange should penalize them for exercising their franchise by denying them the benefits of an Exchange listing for their shares.

As a consequence of their adoption of charter provisions in violation of NYSE listing standards, several listed companies have either given up their NYSE listings or have been notified they will be delisted.

While the Subcommittee's mandate is broader than the question of disparate voting rights, we have determined, because of the pendency of several delisting proceedings based on such provisions and because we have not completed our analysis of responses to the survey described above, that we should address this matter immediately and defer for the moment the consideration of related questions.

The Subcommittee has considered a number of possible courses which the Exchange might pursue.

One such course would be to urge the SEC to take regulatory action to impose uniform qualitative listing standards on all markets.

Although the matter is not free of uncertainty, the Securities and Exchange Commission may have the authority to set the listing standards of self-regulatory organizations. First, it has the authority under the Securities Exchange Act of 1934 to compel self-regulatory organizations to adopt or amend rules; since listing standards are rules, the Commission could perhaps compel their amendment or adoption. Second, under the Act the Commission has the authority to define "qualified" securities eligible to trade in the national market system.

However, this Subcommittee is reluctant to urge that the Commission impose upon all markets uniform listing standards or requirements for shareholder participation. However, if it appears that differentials in such standards result in a significant movement of issuers from markets with rules directed to shareholder participation in corporate affairs to those with lesser or no such rules, then sound public policy may compel the Commission to intervene to protect the integrity of markets and the investors and shareholders of all publicly held companies. In any event, the Subcommittee encourages the Exchange to continue collaborating and cooperating with the SEC and other markets in the effort to afford adequate protection of shareholder participation regardless of the market in which a security is traded.

The Subcommittee urges that the Exchange not abandon its tradition of upholding shareholder participation in the affairs of corporations in which they invest and that the Exchange should properly continue to maintain appropriate qualitative listing standards. The Exchange over the years has been recognized throughout the world as a preeminent advocate of responsible corporate governance; as recently as 1977 it adopted a requirement that listed companies have independent audit committees. This concern of the Exchange has been remarked upon by courts and by investors, and in the opinion of the Subcommittee it is an appropriate role for the Exchange. However, the Exchange must be sensitive to the changes which are occurring in the marketplace, including corporate governance developments, changes which in many cases affect the relevance of standards that were adopted in a different time in response to different environments and problems.

In making the specific recommendations that follow, the Subcommittee has been strongly influenced by two considerations: one, shareholders should have considerable latitude in determining the capital structures of the corporations in which they have invested, they should not be arbitrarily barred from so determining, even if in judgment of others the course adopted may in the long run be harmful to their interests, and they should not be necessarily penalized by forfeiting Exchange listing for their shares when they have lawfully exercised their voting rights; and two, increasingly majorities of "independent" directors on the boards of publicly held companies and independent audit committees provide a dynamic, flexible and responsible safeguard for shareholders, and may be more effective in protecting shareholders than a litany of specific prohibitions.

With these premises in mind, the Subcommittee submits the following recommendations.

An issuer with securities listed on the New York Stock Exchange should not have those securities delisted because of the adoption of charter provisions creating two classes of common stock having disparate voting rights if:

a. The transaction in which the shares with different voting rights are to be issued has been approved by two-thirds of all shares entitled to vote on the proposition;

b. If the issuer had a majority of independent directors at the time the matter was voted upon, a majority of such directors approved the proposal; if the issuer had less than a majority of such directors, then all independent directors approved;

c. The ratio of voting differential per share is no more than one to ten; and

d. The rights of the holders of the two classes of common stock are substantially the same except for voting power per share. With respect to this last condition, some members of the Subcommittee believe the disparity permissible should be limited to voting for directors and some believe payment of a larger dividend to holders of the lesser voting shares should be permissible. We suggest the Public Policy Committee study the limits of permissible disparity with particular care.

We would emphasize that the above recommendations relate only to the standards applicable to issuers with listed securities that take action to recapitalize and are not intended to apply to issuers which apply for listing; the Subcommittee proposes to make recommendations with respect to these at a later date.

The Subcommittee is concerned that the increased concentration of voting power in management which usually flows from arrangements providing for disparate voting rights may pose certain dangers to public stockholders. It might be possible for an acquirer desiring to secure control of the corporation to do so by offering a premium price for the higher voting stock and deny to the public holders of the other type of common stock an equivalent advantage. While the recommendations stated above do not attempt to deal with this danger, we believe it should receive the consideration of the Exchange's Public Policy Committee and the Board of Directors.

In many instances foreign issuers are either compelled by law or practice common in their domiciliary countries to have two classes of common stock or voting trust arrangements which in effect result in two classes. Where it appears that this structure for a foreign issuer is indeed compelled by law or common practice in the country in which it is domiciled, the Subcommittee recommends that such arrangements not be barriers to listing.

If the Exchange were to adopt the proposals above, its standards with respect to disparate voting rights would continue to be considerably stricter than those of any other American marketplace and they would, when considered in the context of the substantial disclosure required in connection with recapitalization proposals, provide significant continuing protection for holders of listed common stock.

Respectfully submitted,

A. A. Sommer, Jr.
Andrew C. Sigler
Co-Chairmen of the Subcommittee

Kenneth J. Bialkin
Theodore F. Brophy
Fletcher L. Byrom
Mendes Hershman
Roberta S. Karmel
John F. Welch
Members

N.Y. STOCK EXCHANGE

Exhibit A

SUBCOMMITTEE ON SHAREHOLDER PARTICIPATION
AND QUALITATIVE LISTING STANDARDS

Members

Andrew C. Sigler
Champion International Corporation
(Subcommittee Co-Chairman)

A. A. Sommer, Jr.
Morgan, Lewis & Bockius
(Subcommittee Co-Chairman)

Kenneth J. Bialkin
Willkie Farr & Gallagher

Theodore F. Brophy
GTE Corporation

Fletcher L. Byrom
Koppers Company, Inc.

Mendes Hershman
Rosenman Colin Freund Lewis & Cohen

Roberta S. Karmel
Rogers & Wells

John F. Welch
General Electric Corporation

Date

Dear :

For almost two hundred years the New York Stock Exchange has been the foremost market place for the trading of securities in the United States and increasingly it is recognized as the preeminent market in the world. Over the years the Exchange has required that issuers listed on the Exchange conform with high standards of disclosure and conduct, including requirements for quarterly and annual reports to shareholders, outside directors, independent audit committees, shareholder votes on changes of control and certain stock transactions, and shareholder voting participation proportionate to equity interests.

The Second Circuit Court of Appeals more than once has recognized the unique characteristics of issuers with securities listed on the Exchange. It has said,

> [L]isting on the New York Stock Exchange carries with it implicit guarantees of trustworthiness. The public generally understands that a company must meet certain qualifications of financial stability, prestige, and fair disclosure, in order to be accepted for that listing, which is in turn so helpful to the sale of the company's

securities. Similarly it is held out to the investing public that by dealing in securities listed on the New York Stock Exchange the investor will be dealt with fairly and pursuant to law.

The Exchange's requirements were adopted in an environment different from the present one. Its disclosure requirements, for instance, were first imposed before the Securities and Exchange Commission and its elaborate disclosure requirements that go well beyond many of the Exchange's came into being. Similarly, many of the Exchange's requirements antedate the widespread practice of having substantial numbers of outside directors on boards and board committees made up largely or exclusively of outside directors. Increasingly large amounts of listed securities are held by institutions which may have somewhat different concerns than individuals with respect to involvement in the affairs of issuers. Many of the Exchange's requirements were designed in a time when unnegotiated offers for securities of an issuer were virtually unknown.

Because of the changes which have occurred with unprecedented speed in the corporate community, the Exchange has been urged by many to review the relevance and desirability of its measures designed to assure shareholder participation in a listed company's affairs. An initial consideration of these urgings by the staff of the Exchange and its advisory committees suggests strongly that such a review is indeed timely. Accordingly we have been asked to head a special committee drawn from the Exchange's Listed Company Advisory Committee and the Legal Advisory Committee to conduct such a review.

Because the Exchange and its policies have enormous impact upon corporate policies and practices not only here but abroad, and because the Exchange is indeed a public institution, we are anxious to have the input of every constituency that may have an interest in these matters.

We would therefore appreciate very much the thoughtful insights and opinions of you and your colleagues with respect to these matters. Without intending to limit the scope of your remarks, we are particularly interested in your thoughts on the following inquiries.

1. Recognizing that the SEC imposes stringent disclosure requirements with respect to such matters and that the principal regulator of internal corporate affairs is state law, does

it continue to be desirable for the Exchange to impose upon listed companies various requirements to assure shareholder participation in the issuers' affairs, such as prohibitions against common stock with limited voting rights (e.g., one class with one vote per share, another with lesser voting rights) and requirements that changes in control, the issuance of substantial amounts of stock in acquisitions, and certain acquisitions from officers, directors, and substantial shareholders be approved by shareholders?

2. Would the Exchange's commitment to shareholder participation in issuers' critical decisions be satisfied if the Exchange's policies were modified to permit certain practices, e.g., two classes of common stock, if such provisions had been specifically approved by shareholders (all shareholders or only those who are not officers, directors or principal shareholders)?

3. Would the Exchange's concerns be satisfied if the sort of actions described in the first numbered paragraph were dependent upon approval by independent directors -- or perhaps by such action plus shareholder action?

4. Should the Exchange urge that the SEC or Congress take measures to cause other markets to adopt shareholder participation measures similar to those which the Exchange has, or in the alternative impose such requirements directly on all publicly held issuers?

5. Rather than modify present requirements, should the Exchange perhaps impose more demanding requirements, particularly with respect to certain actions associated with tender offers, such as "greenmail," "golden parachutes," "poison pills" and the like? If so, which practices would you regard as appropriate for Exchange action?

6. Would your responses to any of the above be different if it appeared that significant numbers of issuers eligible for Exchange listing decided to forego listing to avoid the restrictions imposed by Exchange requirements?

The Board of the Exchange has asked our committee to report to it before the end of the year. Consequently we would appreciate a response from you no later than October 1. These matters are of tremendous importance to American markets and American corporations. We want and need your help and it will be deeply appreciated.

Please address your comment to:

Mr. Richard A. Grasso
Executive Vice President
New York Stock Exchange, Inc.
20 Broad Street - 17th Floor
New York, NY 10005

Sincerely,

Andrew C. Sigler
Subcommittee Co-Chairman

A.A. Sommer, Jr.
Subcommittee Co-Chairman

Exhibit B

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Survey Responses

Constituent Group	Number Surveyed	Responses	
		Number	%
Listed Companies	1,550	309	20%
Member Firms	560	25	4%
Major Institutional Investors	63	11	17%
Legal Profession	700	40	6%
Academia	300	23	8%
State Securities Administrators ("NASAA")	51	7	14%
Other	—	10	—
Total	3,224	425	13%

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Statistical Analysis

Summary of Responses	Grand Total Agree	
	Number	%
1. NYSE should not continue present shareholder participation requirements	207	58%
2. NYSE should modify policy to permit two classes of stock if approved by shareholders	244	79%
3. Approval by independent directors should not be an acceptable alternative to shareholder approval	148	53%
4. NYSE should not urge SEC or Congress to require other markets to adopt shareholder participation measures similar to NYSE	223	76%
5. NYSE should not impose requirements on "Greenmail," "Golden Parachutes," etc.	255	76%
6. Listing considerations should not determine policy initiatives resulting from this review	223	89%

Notes: Not all respondents addressed each of the six issues posed in the request letter.

Percentages relate to the total number of responses to each issue.

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Statistical Analysis

Summary of Responses	Listed Companies Agree		Grand Total Agree	
	Number	%	Number	%
1. NYSE should not continue present shareholder participation requirements	179	68%	207	58%
2. NYSE should modify policy to permit two classes of stock if approved by shareholders	195	86%	244	79%
3. Approval by independent directors should not be an acceptable alternative to shareholder approval	105	52%	148	53%
4. NYSE should not urge SEC or Congress to require other markets to adopt shareholder participation measures similar to NYSE	183	85%	223	76%
5. NYSE should not impose requirements on "greenmail," "golden parachutes," etc.	220	85%	255	76%
6. Listing considerations should not determine policy initiatives resulting from this review	229	91%	223	89%

Notes: Not all respondents addressed each of the six issues posed in the request letter.

Percentages relate to the total number of responses to each issue.

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Statistical Analysis

Summary of Responses	Member Firms		Grand Total	
	Agree		Agree	
	Number	%	Number	%
1 NYSE should not continue present shareholder participation requirements	11	58%	207	58%
2 NYSE should modify policy to permit two classes of stock if approved by shareholders	16	84%	244	79%
3 Approval by independent directors should not be an acceptable alternative to shareholder approval	6	33%	148	53%
4 NYSE should not urge SEC or Congress to require other markets to adopt shareholder participation measures similar to NYSE	6	40%	223	76%
5 NYSE should not impose requirements on "Greenmail", "Golden Parachutes", etc.	5	29%	255	76%
6 Listing considerations should not determine policy initiatives resulting from this review	13	81%	223	89%

Notes: Not all respondents addressed each of the six issues posed in the request letter.

Percentages relate to the total number of responses to each issue.

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Statistical Analysis

Summary of Responses	Major Institutional Investors		Grand Total	
	Agree		Agree	
	Number	%	Number	%
1. NYSE should not continue present shareholder participation requirements	3	23%	207	58%
2. NYSE should modify policy to permit two classes of stock if approved by shareholders	6	67%	244	79%
3. Approval by independent directors should not be an acceptable alternative to shareholder approval	6	75%	148	53%
4. NYSE should not urge SEC or Congress to require other markets to adopt shareholder participation measures similar to NYSE	3	60%	223	76%
5. NYSE should not impose requirements on "Greenmail", "Golden Parachutes", etc.	5	63%	255	76%
6. Listing considerations should not determine policy initiatives resulting from this review	6	86%	223	89%

Notes: Not all respondents addressed each of the six issues posed in the request letter.

Percentages relate to the total number of responses to each issue.

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Statistical Analysis

Summary of Responses	Legal Profession		Grand Total	
	Agree		Agree	
	Number	%	Number	%
1. NYSE should not continue present shareholder Participation Requirements	18	56%	207	58%
2. NYSE should modify policy to permit two classes of stock if approved by shareholders	21	95%	244	79%
3. Approval by independent directors should not be an acceptable alternative to shareholder approval	17	65%	148	53%
4. NYSE should not urge SEC or Congress to require other markets to adopt shareholder participation measures similar to NYSE	22	79%	223	76%
5. NYSE should not impose requirements on "Greenmail," "Golden Parachuttes," etc.	19	66%	255	76%
6. Listing considerations should not determine policy initiatives resulting from this review	17	74%	223	89%

Notes: Not all respondents addressed each of the six issues posed in the request letter.

Percentages relate to the total number of responses to each issue.

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Statistical Analysis

Summary of Responses	Academia		Other		Grand Total	
	Agree		Agree		Agree	
	Number	%	Number	%	Number	%
1. NYSE should not continue present shareholder participation requirements	2	10%	0	0%	207	58%
2. NYSE should modify policy to permit two classes of stock if approved by shareholders	9	45%	2	50%	244	79%
3. Approval by independent directors should not be an acceptable alternative to shareholder approval	13	72%	1	100%	148	53%
4. NYSE should not urge SEC or Congress to require other markets to adopt shareholder participation measures similar to NYSE	8	50%	6	75%	223	76%
5. NYSE should not impose requirements on "Greenmail", "Golden Parachutes", etc.	7	54%	3	38%	255	76%
6. Listing considerations should not determine policy initiatives resulting from this review	9	69%	7	100%	223	89%

Notes: Not all respondents addressed each of the six issues posed in the request letter.

Percentages relate to the total number of responses to each issue.

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Statistical Analysis

Summary of Responses	NASAA		Grand Total	
	Agree		Agree	
	Number	%	Number	%
1. NYSE should not continue present shareholder participation requirements	0	0%	207	58%
2. NYSE should modify policy to permit two classes of stock if approved by shareholders	0	0%	244	79%
3. Approval by independent directors should not be an acceptable alternative to shareholder approval	4	100%	148	53%
4. NYSE should not urge SEC or Congress to require other markets to adopt shareholder participation measures similar to NYSE	1	17%	223	76%
5. NYSE should not impose requirements on "Greenmail," "Golden Parachutes," etc.	2	33%	255	76%
6. Listing considerations should not determine policy initiatives resulting from this review	2	100%	223	89%

Notes: Not all respondents addressed each of the six issues posed in the request letter.

Percentages relate to the total number of responses to each issue.

Subcommittee on Shareholder Participation and Qualitative Listing Standards

Survey Responses - Majority/Minority Positions
Majority Positions

- Permit Dual Class Stock.
- Reduce shareholder participation requirements.
- Oppose NYSE seeking uniformity of markets re shareholder participation requirements.
- Reject NYSE regulatory role re "Greenmail", "Golden Parachutes", etc.

Minority Positions

- Various requirements by the Exchange which promote shareholder participation in issuers' affairs, (primarily voting rights), are neither burdensome nor undesirable
- High quality standards of NYSE do not necessarily detract from, and in fact, may encourage listings.
- A reduction of NYSE policies may bring equally or more burdensome governmental regulation

NOTE: The vast majority of State Securities Commissioners support maintaining current standards.

Senator D'AMATO. Thank you, Mr. Phelan.
Mr. Levitt.

STATEMENT OF ARTHUR LEVITT, JR., CHAIRMAN, AMERICAN STOCK EXCHANGE

Mr. LEVITT. My name is Arthur Levitt, Jr. I am chairman of the American Stock Exchange and I am not enthusiastic about a legislative resolution to this issue.

I am opposed, as I have said, to a legislative resolution of this issue. That should be a last ditch response to our self-regulating bodies failing to discharge a compelling national mandate. Indeed if we are incapable of discharging what I regard to be a vital national responsibility, then the SEC, in my opinion, has the power and a variety of means to resolve the issue. Hopefully, we will be able to obviate the need for Federal legislation by agreeing upon a mechanism whereby American investors will recognize that their voting rights are being fiercely protected by the self-regulating process. Thank you.

Senator D'AMATO. Thank you, Arthur.

[The complete prepared statement follows:]

Statement of Arthur Levitt, Jr.

Chairman, American Stock Exchange, Inc.

Before the Securities Subcommittee
of the Senate Committee on Banking,
Housing and Urban Affairs
June 12, 1985

My name is Arthur Levitt, Jr. I am the Chairman of the American Stock Exchange. I appear before this subcommittee today to express my views concerning the proposal of a Subcommittee on Shareholder Participation and Qualitative Listing Standards of the New York Stock Exchange (the "NYSE Subcommittee") that the NYSE abandon its longstanding rule requiring that its listed companies provide all common shareholders with one vote for each share owned. Two weeks ago, I appeared at a hearing of the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Energy and Commerce Committee on this issue. Next week, I have been invited to appear before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, where the NYSE proposal is one of several major issues to be discussed. Clearly, the NYSE proposal has become a matter of broad general concern, and this is good.

I hope the New York Stock Exchange will not amend its rule protecting the voting rights of common shareholders, and I am here today to tell you why.

The rule change proposed by the NYSE Subcommittee, which is now pending consideration by that Exchange's Board, would allow voting arrangements that are permissible under state law. The voting arrangements would also not violate the rules of the AMEX, or of the National Association of Securities Dealers. The arrangements would not be prohibited by existing rules of the Securities and Exchange Commission and, indeed, it is vigorously debated whether the SEC has the authority under federal law to disapprove such a change in the unhappy circumstance that the NYSE were to file formally with the Commission for its approval. The issue is therefore not principally one of law. The issue is one of good policy and good judgment.

I should also like to make clear at the outset that the listing standards of the American Stock Exchange, unlike those of the New York Stock Exchange, have for many years allowed a corporation that has two classes of common stock, one of which has heavier voting rights than the other, to be listed for trading on the AMEX under standards similar to those proposed by the NYSE Subcommittee. Several corporations listed on the American Stock Exchange have such A-B stock structures, such as, for example, The New York Times Company, Wang Laboratories, and The Washington Post Company. Further, it could be -- though I have no way to be certain -- that if the New York Stock Exchange were to relax

its listing requirements to allow an A-B stock structure, some companies now listed on the American Stock Exchange might transfer to the New York Stock Exchange; if they did so, the American Stock Exchange would lose substantial revenues in the form of annual listing fees and transaction charges.

In these circumstances, it would be easy to dismiss the views I express here today as inspired by the institutional self-interest of the AMEX. But I believe the arguments reviewed here are weighty ones; they stand by themselves and have been advanced by leading commentators on corporate governance issues. As to the institutional self-interest of the AMEX, I shall return to that point later in my remarks.

The heart of the matter is this: We are today witnessing in the world of corporate finance a quite accidental intersection of two wholly unrelated phenomena. The first is the rash of corporate takeovers, leveraged buy-outs, goings private, and the like, that is sweeping corporate America. The other is the increasing competition among securities marketplaces, spurred to a considerable extent by the gradual development and emergence of a national market system for the trading of securities mandated by Congress in 1975. I shall comment briefly on each of these phenomena.

The Takeover Phenomenon

This Committee needs no rehearsal on the facts of the current epidemic of corporate takeovers. Each day's financial news reports a new case. As a result, almost every corporate executive goes to bed each evening braced to be awakened by a call to general quarters and the order, "Prepare to repel boarders". Executives who have worked a lifetime for a company feel threatened. And they are angry as each day's news brings word of another corporate ship that has been taken over. These executives have a personal interest in retaining their command on the bridge, of course. But they also have in the main a deep loyalty and dedication to their companies, and their shareholders -- and a conviction that those who organize and lead the boarding parties have loot and booty in mind more than the interest of the ship or of the ship's owners. Only the bitterest cynic believes that a naval captain fights for his ship only because he enjoys being captain.

Corporate managements are not only angry and threatened, they are fighting back. I don't blame them in the least. I would do the same.

From that perspective, corporate executives see in the use of A-B stock plans a stalwart -- perhaps impregnable -- defense structure against takeovers. They believe that with properly designed A-B stock structures, they can re-establish

a combat balance on a field which they see as currently favoring the invader.

I think there is no doubt that the proposed change of the New York Stock Exchange's listing rule will lead many corporate managements to design, and to persuade their current shareholders to vote in favor of installing, A-B stock defenses with the voting power of the corporation concentrated in relatively few hands. If I am wrong about that prediction, then I should not be here testifying today. If I am right about it, as I think I am, I believe all of us -- the New York Stock Exchange, the AMEX, other exchanges, the SEC, this Subcommittee, the Congress, the public, and corporate managements -- should be deeply concerned with the long-term prospect of such a development.

It makes sound economic and social policy sense that common shareholders should ultimately control the corporations and their managers.* Common shareholders -- the

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* This portion of my remarks draws in part, with permission, upon a letter of April 8, 1985 from Bayless Manning, Esq. to A.A. Sommer, Jr., Esq., a former SEC Commissioner and chairman of the New York Stock Exchange Subcommittee, regarding the proposed rule change. Mr. Manning is a partner in the New York law firm of Paul, Weiss, Rifkind, Wharton & Garrison, was formerly dean of The Stanford Law School, is a consultant to the Corporate Governance Project of the American Law Institute, is chairman of the editorial advisors of the journal, The Corporate Board, and has written extensively on subjects related to corporate boards of directors. See, as a recent example, "The Directors's Duty of Attention: Time for Reality", 39 The Business Lawyer 147 (1984).

residuary claimants to the income and assets of the corporation -- are in the long run those who have the deepest inherent interest in corporate efficiency, productivity and profitability. Those factors all work to the advantage of the enterprise and collectively enhance the performance of the national economy as a whole.

The principle of the central role of shareholders is widely accepted by the public and by the law. Those who have sought reform of corporate practices throughout this century have properly done so in the name of benefitting the shareholders -- those who are perceived as the ultimate owners and legitimately the ultimate controllers. Corporate executives and directors are not wise to blur that widely endorsed perspective on the primary role of shareholders. Those who would seek to tamper with the present delicate balance between shareholders and directors as their representatives in our corporate governing machinery do so at great ultimate peril to our market economy.

Suppose corporate executives were to come to be perceived by the public as unreachable, as entrenched behind formal barriers beyond the power of proxy fight or tender offer, and as able to prevent ballot-box expression of views by holders of the residual economic claim to the incorporated enterprise? Suppose corporate managements come to be perceived as having made themselves accountable to no one? Suppose directors and managers come to be perceived as having circled the wagons to preserve their own jobs, perquisites and job security?

If those shifts in public perspective toward corporate management were to occur -- and I believe they might well occur if corporate managers leap to use A-B stock structures as takeover defenses -- then we must expect the imposition upon corporate managers of other sources of accountability. Out of that reaction would likely emerge a more regulated American corporate community built on more restrictive legal controls of business activity. That result would be deplorable. The modern corporation, while far from ideal, has proved itself the most successful institution yet designed by any society to carry out the vital tasks of capital assembly, resource allocation, production, employment and distribution.

Is this unpleasant projection alarmist? I think not. Two or three widely publicized unsavory episodes are often all that is required to set off a tremor of new regulation. Moreover, it is more than casually interesting that one of the historical sources of the New York Stock Exchange rule against non-voting stock lay in the use of such shares in the public utility industry in the 1920's: non-voting stock was a key device that underlay the pyramiding of personal control in that industry and that ultimately led to collapse, to a tragic loss of public confidence in our capital markets, and to direct federal regulation in the form of the Public Utility Holding Company Act. That memory is dim today compared to the immediacy of the desire for protection against the red eyes circling in the night. But history that is forgotten is history that must be painfully relived.

I am not one of those who view the current wave of corporate takeovers as just good, old-fashioned, healthy market-clearing by price. I suspect, rather, that some very basic things are happening in our corporate economy that we do not understand very well and that today's corporate takeovers are merely manifestations of those deeper changes. I also believe we can hardly blame corporate managements for wanting to protect themselves and their life work.

But dropping the New York Stock Exchange's rule against limited voting stock is not the way to achieve that purpose. The negative side effects of that therapy will be much greater than the benefits. Let me detail a number of these negative effects - other than the sense of disenfranchisement that would ultimately lead to legislative action.*

(1) If the vote is taken away or watered down, public investors will in time feel that the cards are stacked against them by some inside group that controls the votes. Before long, they will no longer want to invest in stock.

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* Concerns similar to those enumerated here have been voiced by John C. Whitehead, until recently Co-Chairman of Goldman, Sachs & Co. and a former director of the New York Stock Exchange (see, Whitehead, "Don't Bend the Big Board's Rules", FORTUNE, March 18, 1985, at 185) and Bevis Longstreth, Esq., a partner in the law firm of Debevoise & Plimpton and a Commissioner of the SEC from 1981 to 1984 (see "Unbundling the Vote From Common Stock -- An Issue Worthy of National Debate", address by Mr. Longstreth at the Seminar on Boards of Directors, Northeastern College of Business Administration, February 13, 1985). Copies of Mr. Whitehead's article and Mr. Longstreth's published remarks are attached for the record of this hearing.

(2) Much of our nation's wealth and resources will end up in the hands of self-perpetuating private bureaucracies. If we allow management to use this ultimate anti-takeover device, our entrepreneurially driven competitive system of product and service delivery would be weakened.

(3) Outside shareholders will suffer immediate and large wealth losses. Recent instances of creating two classes of common stock with disproportionate voting rights have demonstrated that this is the case.

(4) Severing voting power from equity ownership, the two principal indicia of ownership, will totally distort the concept of a common equity security.

(5) Public shareholders will not receive the benefits of a takeover battle. Rather, they would stand on the sidelines while the voting stock, in the hands of management or a control group, will receive any premium.

(6) Proxy battles will be effectively eliminated and the proxy rules of the Securities Exchange Act of 1934, which are designed to protect and foster shareholder democracy and corporate governance, would be rendered void.

Serious public intellectual and professional debate is now at last in full flood about the pros, cons, causes and remedies for corporate takeovers. The

law in the field is now being rehammered daily on judicial forges in the traditional ways of the Common Law. And administrative and legislative agencies are, for the first time, grappling with the problem in many forms and forums. Two years from now the takeover phenomenon will surely be seen differently, be understood more deeply, and be manifested in different ways than it is today. My own guess is that varieties of changes will occur that will slowly but steadily reduce the current atmosphere of panic in the boardroom. And the SEC will have a key role to play in that evolving process. Those gradual changes are the best therapies for dealing with the complex problem of takeovers. Disenfranchising large blocks of shareholders is, by contrast, an effort at a "quick fix."

THE CHANGING SECURITIES MARKETS

The second source of causation for the proposed change in the rules of the New York Stock Exchange is also not difficult to identify. It is competition. Fundamental changes in the economics and technology of trading have given rise to a new competitive dynamic in the securities industry. Once separate market segments, such as banking and brokerage, have become increasingly intertwined. Customers have evolved into institutions. Financial institutions are in turn becoming brokers and dealers. Traditional dividing

lines everywhere have been blurred. These changes are transforming our securities marketplaces as well.

Among markets, however, competition has also been the result of policy initiatives of Congress and the SEC toward creation of a national market system. These initiatives, intended to eliminate unnecessary constraints on market making activity and choice of market by customers and brokers and thereby to increase competition for order flow, have created powerful competitive pressures on the NYSF and AMEX, and between them. SEC rules permit over-the-counter market makers to continue to make markets in stocks which list on the exchanges, thus providing alternative markets for listed stocks. The SEC-mandated linkages to facilitate trading between the exchanges and the OTC market have diffused the traditional separation between the auction market and the dealer market. SEC rules requiring trade and quote reporting for certain OTC stocks have enhanced the visibility and stature of the OTC market. In particular, SEC designation of a broad group of NASDAQ securities as "National Market System Securities" has given the NASD a powerful marketing tool which it has used to discourage listing and encourage delisting from exchanges.

The result of these initiatives is that securities markets, which once did not compete with each other at all, have moved beyond competition for order flow. The exchanges and the NASD are now competing for product. The rush to

create unique new products, the advent of multiple trading in some stock options, and the possibility of exchanges obtaining unlisted trading privileges in OTC securities evidence this phenomenon.

Competition is the heartbeat of the American economy, and I yield to no person in my commitment to a free market economy. But the factors of competition should be mainly price and services. Where a system of healthy self-regulation is in place, designed to protect companies and shareholders alike, competition should not take the form of relaxation or dismantling of that pattern of regulation. Airlines and manufacturers of automobiles should not compete by saving money on their passenger safety equipment. Exchanges should not compete for listings by discarding their shareholder safety standards. Surely Congress never intended that result.

The stock exchanges have stringent qualitative listing requirements. At present, the NASD has none. The New York Stock Exchange has restrictions on the creation of limited voting stock. The NASD has none. As corporate managements find that it has become possible for their stock to be traded over-the-counter in the highly touted NASDAQ "National Market System", the cost to the exchanges of maintaining higher standards becomes high indeed. Over the past several years, the NYSE has delisted companies which violated its corporate governance rules. Some of these companies now trade in the

NASDAQ/NMS, a few on the American Stock Exchange. The pressures that are being brought to bear on the New York Stock Exchange through the availability of an alternative, the less-regulated OTC market, are felt at least equally by us at the American Stock Exchange. The American Stock Exchange has paid the price of higher standards in the loss of some new listings to the OTC market by companies wishing to avoid the regulation imposed by an exchange listing. And while the AMEX permits a two-class voting structure, if companies listed on the New York Stock Exchange are permitted to establish a two-class structure, then more companies listed on the AMEX will be tempted to do so. In short, the AMEX stands on this issue in the same basic position as the NYSE. We too, feel the constant pressure of NASDAQ competition in the direction of lowering standards that are a traditional bulwark of investor protection. And so we can empathize with the NYSE in its current dilemma.

Nonetheless, we believe that the NYSE's proposed response to these pressures is the wrong one. To respond to takeover fears by fundamental alteration of the machinery of corporate democracy is extremely risky. In any longer view, it threatens to create a disaffected investing public.

I do not want a race to the bottom. I do not even want a race downhill. What is needed now is responsible cooperation among the self-regulatory organizations which comprise our securities markets. The New York Stock Exchange

should not lower its standards. The NASD and the American Stock Exchange should together raise theirs. Chairman John Shad of the SEC has clearly recognized the dangers inherent in the NYSE proposal and has exhorted the exchanges and the NASD to take this very course, in the name of responsible self-regulation. I am especially pleased that the Chairmen of the Amex, NYSE, and NASD will meet on June 14 to discuss how we can structure a private sector initiative which ensures that our self-regulatory responsibilities are fulfilled, and I for one am optimistic that this can be achieved.

FORTUNE

March 18, 1985

BY JOHN WHITEHEAD

DON'T BEND THE BIG BOARD'S RULES

Allowing shares with unequal voting rights would drive investors out of the stock market.

■ It appears that the New York Stock Exchange is about to amend its rules to permit the listing of common stock that has only limited voting rights. The exchange is acting because several large companies, trying to guard against hostile takeovers, have recently created new classes of stock with limited voting rights, even though such action requires them to be delisted under current Big Board rules. The NYSE naturally wants to keep the listings rather than see the companies move to the American Stock Exchange or the over-the-counter market.

While at first glance this may not appear a major calamity, I believe that this action, if it occurs, will have serious negative implications for the whole capitalist system. There are 4.3 million individual stockholders in the U.S. The broad public ownership of our great American companies is one of the things that distinguishes our system from those of countries such as Germany and Japan and has made our capital market the deepest and most liquid in the world.

The one-share, one-vote principle has long been a cornerstone of this corporate democracy. If it is taken away or watered down, public investors will in time feel that the cards are stacked against them by some inside group that controls the votes, and they will no longer be willing to own their "share of American business," as the exchange's advertising slogan used to state. Furthermore, stockholder voting rights are an important reminder to management that it should always act in the stockholders' interest, a reminder that should not be given up lightly.

The NYSE has always been the champion of stockholder rights, and it will be a sorry day if the exchange begins to water down its principles to retain the listings of a handful of companies. Over the years, the exchange has required that listed companies conform to high standards of disclosure and conduct, including strict requirements for outside directors, independent audit committees, prompt dissemination of news, quarterly and annual reports to shareholders, and shareholder voting participation proportionate to equity interests. The exchange has always represented to the investing public that it will be treated fairly by dealing in securities listed there. Surely equal voting rights are an essential element of fairness. One wonders where the process will stop if the exchange indicates that listed companies can violate its rules with impunity.

A special committee of the exchange that considered this matter has recommended that the listing requirements be changed to permit limited voting stock provided that the voting differential per share is no more than 1 to 10. I believe this means that every listed company could issue a new class of stock that could have as little as 5% of the equity and yet have 50% of the vote. Put another way, the previously outstanding shares, representing 95% of the equity, would have less than a majority of the votes. Is this the corporate democracy for which the NYSE stands?

Part of the pressure for making this change comes from a legitimate fear on the part of corporate managements and directors of the abuses taking place in the takeover area. The unfriendly stockholder who

JOHN WHITEHEAD *is a limited partner in and former co-chairman of the investment banking firm of Goldman Sachs & Co. He is also a former director of the New York Stock Exchange.*

purchases 5% or 10% of a company's shares, threatens a takeover with the objective of breaking up the company, and then accepts a greenmail bribe as the price of going away is certainly a less than admirable character on today's corporate scene. But to attempt to solve this problem by taking away stockholder voting rights is akin to burning down the toolshed to get rid of the beehive.

Perversely, the result of the committee's proposal is likely to be the opposite of what it assumes. If 5% of the equity now has 50% of the vote, the greenmailer's task is made easier, not harder. He can now buy control with a much smaller investment. He can afford to pay two or three times the market price for the heavy voting stock that represents control. The poor public stockholder, left with only his limited voting stock, will never receive any benefits from a takeover battle but will stand on the sidelines watching the price of the heavy voting stock rise to several times the price of his shares.

ANOTHER PROVISION of the special committee's report recommends that listing of limited voting shares be permitted only when their issuance has been approved by a two-thirds vote of all shareholders. The committee co-chairman, Andrew C. Sigler, chief executive of Champion International Corp., said in announcing the recommendations: "If two-thirds of the shareholders vote for something, who are we to impose our judgment that they're not right?" This certainly has an appealing commonsense ring to it. But what if two-thirds of a company's shareholders voted to disband the audit committee or discontinue the publication of quarterly and annual reports? I doubt that the exchange would permit continued listing of the company's stock. Standards of listing should be set by the exchange, not by a corporate vote.

Then there is the matter of protecting the minority. What about the one-third of the shareholders who, having bought their shares when they had one vote, find, after being on the losing end of a two-thirds vote, that their shares have only one-tenth of a vote? Do they not deserve more protection? I am not a legal scholar, but I doubt that our Constitution would permit a group of citizens, by a two-thirds vote, to turn over their political voting rights permanently to someone else. To me, the principle of corporate voting rights is similar.

Consider also the changing stockholder list. The stockholder who may have voted to give up his voting rights one day will very likely sell his stock to someone else the next day. I believe stockholder turnover in the average company is about 25% a year. So after a few years the limited voting stock is held by a whole new group of stockholders, none of whom voted to limit their voting rights. Does that seem fair for them?

Finally, there is the matter of family control. Take the case of a company that has gone public and is listed on the NYSE. The founding family still owns two-thirds of the stock, the public one-third. The company proposes that a new limited voting stock be issued pro rata to all shareholders. The proposal is supported by the family and passes, even if all the public shareholders vote against it. Now the family sells down to only 10% or so of the equity but keeps its heavy voting stock and keeps voting control of the company. Is that the intent of the exchange's proposal? Is that fair to the public stockholders? I conclude that the mere fact that a new class of limited voting shares has been approved by a two-thirds vote of the stockholders is not sufficient reason for the exchange to permit its listing.

If the NYSE lowers its standards, I fear that what has been called the race to the bottom will quickly occur, that all companies will move to whatever is the lowest common denominator the exchange will permit. I fear that underwriters that have resisted underwriting nonvoting and limited voting shares, including my own firm, will be unable to hold the line against competitive pressure. I fear that corporate democracy as we have known it will disappear.

I urge the exchange directors to consider not only whether this proposal benefits the exchange's competitive position and its listed companies, but also whether it benefits public stockholders. I urge the Securities and Exchange Commission to consider whether it is truly in the public interest to allow shareholder voting rights to be revoked. Ultimately, the SEC must approve changes in the exchange's rules. One possible alternative would be for the SEC to require that other markets upgrade their rules to be similar to the present rules of the NYSE.

The public shareholder is at the heart of the free-market system. If we treat him badly, he will not be there when we need him. ■

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Unbundling the Vote from Common Stock -- An Issue Worthy of National Debate

Address of

Bevis Longstreth

Seminar on Boards of Directors
Northeastern College of
Business Administration

February 13, 1985

F. uary 13, 1985

Unbundling the Vote from Common Stock -- An Issue Worthy of National Debate

Since 1926, the New York Stock Exchange has prohibited the listing of non-voting or diminished voting common stock. In a January 3, 1985 press release, the New York Stock Exchange announced that a subcommittee -- known as the Subcommittee on Shareholder Participation and Qualitative Listing Standards -- had recommended to the Public Policy Committee of the Exchange's Board of Directors that listed companies, with shareholder approval, be permitted to create a class of common stock with disproportionate voting rights.

If this recommendation is adopted, will it simply be a coda to the process of separating ownership from control, identified more than half a century ago by Berle and Means (i.e., the last symbolic nail in the long closed coffin of shareholder democracy) or the overture to new, and perhaps fundamental, change in the character of corporate activity?

Historical Perspective

In 1932 Berle and Means documented their thesis that corporate ownership had become separated from control.[1/] This reality introduced the dilemma of legitimacy derived

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1/ Berle & Means, The Modern Corporation and Private Property (Harcourt, Brace & World, 1967).

from the growing dominance of the corporate form, the increasing decision-making power of management and the increasingly passive position of shareholders.

In 1959 Edward S. Mason's The Corporation in Modern Society brillantly carried forward the debate, without removing the dilemma. In that book Mason observed that "the equity owner is joining the bond holder as a functionless rentier."

Another contributor, Abraham Chayes, wrote:

> A priori, there is no reason for [the shareholders] to have any voice, direct or representational, in the . . . decisions on prices, wages and investment. They are no more affected than nonshareholding neighbors by these decisions. In fine they deserve the voiceless position in which the modern development left them.

Despite these observations regarding shareholder democracy, it continued to be paid homage:

- By the New York Stock Exchange -- which continued to deny listing to corporations that had two classes of common stock with disproportionate voting rights, and in other ways buttressed the view that the right to vote, pro rata, was an indivisible part of owning common stock in a listed corporation.
- By the SEC -- which in 1941 first adopted what is now Rule 14a-8 -- the shareholder proposal rule -- and has maintained it more or less intact ever since.

- By the Courts -- where in significant opinions the legitimacy and importance of the shareholder voice was acknowledged. For example:
  - Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970):

    > We think that there is a clear and compelling distinction between management's legitimate need for freedom to apply its expertise in matters of day-to-day business judgment, and management's patently illegitimate claim of power to treat modern corporations with their vast resources as personal satrapies implementing personal political or moral predilections. It could scarcely be argued that management is more qualified or more entitled to make these kinds of decisions than the shareholders who are the true beneficial owners of the corporation;

  - First National Bank of Boston v. Bellotti, 435 U.S. 765, 794 (1977):

    > Ultimately shareholders may decide, through the procedures of corporate democracy, whether their corporation should engage in debate on public issues. Acting through their power to elect the Board of Directors or to insist upon protective provisions in the corporation's charter, shareholders normally are presumed competent to protect their own interests.

Of course, until the sixties, shareholder democracy didn't pose a significant threat to management. What Chayes wrote in 1959:

> Suffrage was exhausted of reality since it was neither informed nor organized. Despite the forms of electoral control, management became in all but rare instances an 'automatic self-perpetuating oligarchy' in Adolph Berle's phrase.

continued -- in the main -- to be true until the sixties. There were, to be sure, occasional proxy contests for election to the Board, but the level of activity, as reported by the SEC, remained fairly constant over the thirty year period from 1950 to 1980 -- on average some 25 contests per year, of which only about 17, on average, challenged control of the whole Board. Since insurgents won only about 15% of these challenges, the high cost and low odds may explain the small and fairly constant number of proxy contests started over the years.

But in the late sixties other changes were occuring. In 1969, Saul Steinberg's attempted hostile takeover of Chemical Bank signaled a possible change in the rules of the game -- a change that did, indeed, occur -- taking hold gradually through the decade of the 70's to the point where now it is fully realized, with 100 and more third party tender offers being made each year, involving increasingly large sums of money. To savor the change, consider that (as reported by John Brooks in The Games Players), Steinberg's two investment bankers, White Weld and Lehman Bros., called him not to bid for the deal, as would be the case today, but to advise him that they would refuse to participate at all in any Leasco tender offer for Chemical.

The corporate franchise was beginning to be used in other ways as well. Starting in 1970, Campaign GM and its progeny signaled an increasingly sophisticated use of

the proxy machinery to assert the slumbering powers of shareholder democracy. The two proposals voted on in Campaign GM-Round I would have established a shareholders' committee on corporate responsibility and increased the board by three, to be elected by the public as its representatives. Although neither proposal got as much as 3%, the impact on GM and other large corporations was profound. As Professor Phillip Blumberg noted at the time:

> Campaign GM-Round I represents the decisive event in the politicalization of the corporation . . . . [I]t shattered for all time the pattern of institutional neutrality under which the institutional shareholder . . . automatically voted its shares for management.

These changes -- which in certain specific respects increased the reality of shareholder democracy -- unleashed as well increasing pressures to cut back on that reality. The Williams Act was passed to halt, among other things, the "Saturday night special."

And responding to corporate management and perceived abuses, the SEC effected changes in its shareholder proposal rule to limit its use by public interest advocates of one sort or another.

Recent Events

Once the hostile takeover genie was out of the bottle, it grew to uncommon size and acceptance. Takeovers increased in quantity and competitiveness, giving rise to creative bidding strategies (front-end loaded, two tier

and bootstrap bids), and grew in size, so that no corporation, however large, was immune from an uninvited bid.[2/] Indeed, in 1984 we entered the era of the "billion dollar bid" (e.g., Gulf Oil at $13.3 billion; Shell Oil at $5.5 billion; Marathon Oil at $3.3 billion; Esmark at $2.6 billion; Citiservices at $1.9 billion; Texas Gas Resources at $1.6 billion and Petrocline at $1 billion).

As increased aggressiveness and imagination were deployed by hostile takeover specialists, corporate managements developed defensive mechanisms to defeat them, including such colorfully named defenses as shark repellents, crown jewel options, pac-man defenses, issuer share acquisitions, blocking preferreds, poison pills and the payment of greenmail.

In aid of management, the courts have, in the main, encouraged an "anything goes" attitude in fending off the hostile "takeover entrepreneur" (as Martin Lipton calls him), sheltering the defensive strategies with the all-but-impregnable rule of "business judgment".

This rule has been interpreted to permit almost every defensive maneuver yet developed by incumbent management. Whether it is the lock up stock options in Data Probe

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2/ The takeover is even being experimented with as a political device. Jesse Helms is leading an effort to achieve a conservative takeover of CBS through small purchases by conservatives throughout the nation, hoping thereby to alter its editorial policies in ways more to his liking.

Acquisition Corp. v. Datatab, Inc.[3] and Buffalo Forge Company v. Ogden Corp.,[4] the buyout at a premium in Cheff v. Mathes,[5] the standstill agreement in General Portland Inc. v. LaFarge,[6] the self tender in Martin Marietta Corp. v. Bendix Corp.,[7] or the sale of a key asset in Whittaker Corp. v. Edgar,[8] all one needs is "good faith" and some reason other than self-interest to invoke the presumption in favor of management. The burden of rebuttal for one who would challenge management, once the business judgment rule has been introduced, is heavy. In Johnson v. Trueblood, the Third Circuit said "the plaintiff must make a showing from which a fact-finder might infer that impermissible motives predominated in the making of the decision in question."[9] As Judge Cudahy noted in his dissent in Panter v. Marshall Field, the effect is to "clothe directors, battling blindly to fend off a threat to their control, with an almost irrebuttable presumption of sound business judgment."[10]

3/ 722 F.2d 1 (2d Cir.), rev'd 568 F. Supp. 1538 (S.D.N.Y. 1983).

4/ 717 F.2d 757 (2d Cir. 1983).

5/ 199 A.2d 548 (Del. 1964).

6/ Fed. Sec. L. Rep. (CCH), ¶ 99148 (N.D. Texas 1981).

7/ 549 F. Supp. 623 (D. Md. 1982).

8/ 535 F. Supp. 933 (N.D. Ill. 1982).

9/ 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981).

10/ Panter v. Marshall Field, 646 F.2d at 299.

Just a few weeks ago, in blessing the "poison pill" preferred stock rights dividend plan of Houschold International, Inc., Vice Chancellor Walsh of the Delaware Court of Chancery stretched the business judgment rule to new lengths.11/ Through a complicated set of rights, the preferred would force any would be acquiror to obtain approval from the Household board of directors. Adopted without shareholder consent, the "poison pill" preferred would effectively prevent unsolicited tender offers.

While acknowledging that the plan was adopted by the board of directors "to deter hostile takeovers," the Vice Chancellor concluded that it was "not intended primarily for entrenchment of management and serves a rational corporate purpose" -- that is the deterrence of hostile takeovers. But this is simply juggling with words. Since hostile takeovers are the principal means by which management loses control, the plan might as easily have been described as being intended primarily to retain control -- that is, entrench management. If this decision stands, it would seem to be virtually impossible to show that a primary purpose of an absolutely watertight defensive maneuver was to retain control.

Incidentally, one should not blame management, or its outside directors, for their remarkably effective

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11/ Moran v. Household International, Inc. (Del. Ch. 1985).

use of the business judgment rule to shelter self-preserving strategms. They are doing only what the law, as interpreted by judges, allows. The villains -- if any -- in this piece may be the judges, and if not them, then the law itself.

As the takeover game grows, one excess begets another with almost Newtonian certainty. Public dissatisfaction has grown too, as reflected in:

- the SEC's appointment in 1982 of the Advisory Committee on Tender Offers, to re-examine the premises and evaluate the operating experience under the Williams Act; and
- the hearings on Takeover Tactics and Public Policy held in 1984 before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Energy and Commerce Committee -- a committee, incidentally that was substantially enlarged this year due to Congressional interest in the subject.

Testimony before the SEC's Advisory Committee and Tim Wirth's Sub-Committee suggests that many people think the system by which corporate ownership and control change hands needs fixing. Martin Lipton testified "that very serious takeover abuses have developed in recent years." Bruce Wasserstein testified that we can and should "do better" than today's system, and charged the SEC with being too equivocal about the report of the Advisory

Committee. Others testified to having similar levels of dissatisfaction.

While many agree the system needs repair, there is no agreement on the solution, and that is precisely because there is no broad consensus as to what the problem is. Some have focused on the alleged negative economic and social consequences of hostile takeovers. In this portrait management is painted as the beleaguered hero, beset by hostile raiders who would usurp its position, misuse the corporation and injure its shareholders. To allow such threats (the argument goes) would be hurtful to corporate America, preventing management from taking the long view with any confidence that it would be around to see the results of its long-term planning. William Norris of Control Data Corporation presented this point of view in testimony before Congressman Wirth. He would require disclosure of the impact of a takeover on all corporate constituencies and a vote by the shareholders of both the target company and the offeror. Congressman Rodino -- in his proposed Hostile Takeover Act of 1984 -- would make a change of ownership by tender offer unlawful unless approved by the independent directors of the target company. Both proposals would work a major shift in favor of incumbent management and against takeover activity.

Others focus on alleged benefits from takeovers of any sort and would remove rules that tend to inhibit takeover activity. With control separated from ownership, goes the argument, the threat of a proxy fight or hostile tender is the principal, and most effective, means of assuring adequate accountability of management to shareholders and optimum efficiency in the deployment of corporate assets. Professors Frank Easterbrook and Daniel Fischel of the University of Chicago are proponents of this point of view, arguing for a rule of management passivity in the face of a hostile take-over attempt.

Meanwhile, as the debate continues, so too does management's search for the ultimate defense against the hostile takeover. This search is leading to the use of non-voting or limited voting stock. With the growth and acceptance of NASDAQ as a national trading market competitive with the Big Board, New York Stock Exchange-listed companies are seeking the protection of a two class common, and are willing to delist if necessary to escape New York's belief in shareholder democracy. As earlier noted, the New York Stock Exchange has prohibited the listing of non-voting stock since 1926. NASDAQ, however, has no such requirement. Nor do most state corporate laws bar the issuance of non-voting stock.

Management's willingness to use two class common as a protection against takeovers may be signalling a "sea

change" in our corporate system of governance. Over the past eight years, six companies have been delisted by the New York Stock Exchange for violating one or more of its corporate governance rules: Wang Laboratories, Lynch Communication Systems, Fotomat, Figgie International, A.O. Smith and Norlin. Not all of these plans were even put to shareholders for approval. And for the most part, those plans that were put to shareholders involved issuers with substantial management-controlled holdings, making the result a foregone conclusion.

It was these competitive pressures that led the Exchange to commission a study of its corporate governance rules -- particularly the rule against two classes of common stock with disproportionate voting rights. Pending the results of that study, the Exchange adopted a moratorium on further delistings due to violations of its corporate governance rules. At least three companies -- Coastal, Gearhart Industries and Dow-Jones & Co. -- are temporarily sheltered from delisting by reason of the moratorium.

The Subcommittee report, while urging the Exchange "not to abandon its tradition of upholding shareholder participation in the affairs of corporations", nonetheless recommended that listed corporations be permitted to create two classes of common with disproportionate voting rights -- subject to the approval of shareholders holding two-thirds of the outstanding -- whether or not affiliated with management.

Framing the Issue

In all likelihood, the New York Stock Exchange will approve some change along the lines of its Sub-committee's report. Before that change can become effective, however, the SEC will have to approve it under section 19(b) of the Securities Exchange Act of 1934. In this way the issue becomes framed for public debate. Congress, with its oversight role, will be keenly interested in how the SEC handles this issue. Beyond that, the interest in take-over tactics already demonstrated last year by the 98th Congress will carry forward to the 99th, which will find the two class common issue irresistible.

At the SEC level, there are uncertainties as to the role it has the authority to play. Section 19 gives the SEC in subsection (b) the responsibility of reviewing and approving exchange and NASD rules (if they are consistent with the requirements of the Exchange Act) and in subsection (c) the power to abrogate, add to or delete from such rules. Do these powers apply to rules of corporate governance, such as those of the Big Board regarding common stock? Suppose the SEC thought it preferable to impose on the other exchanges and the NASD a rule comparable to the one now in place at the New York Exchange. Would it have the power to do so? What does the power to approve mean, if the SEC couldn't impose such a rule itself? But on what basis might

it disapprove the recommended change? In addition, Section 11A of the Exchange Act gives the SEC the authority to define "qualified securities" eligible to trade in the national market system. Would this power permit the SEC to set minimum voting standards for "qualified securities?"

There are differing views on these questions. How they are answered by the Commissioners will have implications on Capitol Hill and for the nation generally.

Imbedded in the coming debate is the issue of corporate legitimacy (questions about the legitimacy of private power are a form of Congressional catnip -- hence the conclusion that this issue will be irresistible on Capitol Hill). In the past, our larger public corporations have been principally held accountable -- and thus legitimized -- through market forces operating at three levels:

(i) in the market for their goods and services;

(ii) in the market for capital; and

(iii) in the market for corporate control.

Added to these market forces are the policing mechanisms of the antitrust laws and laws against self-dealing and other inefficient agency behavior.

If two class common is permitted, and becomes widely used, one of the market mechanisms for accountability will be removed. The significance of this step for our corporate society is worthy of wide debate. Indeed, this

point did not elude the New York Stock Exchange's Subcommittee on Shareholder Participation and Qualitative Listing Standards. Its concern was over a "race for the bottom" as marketplaces compete for listings and trading volume. After suggesting that the SEC may have authority to establish minimum standards for shareholder participation, the Subcommittee observed:

> [I]f it appears that differentials in such standards result in a significant movement of issuers from markets with rules directed to shareholder participation in corporate affairs to those with lesser or no such rules, then sound public policy may compel the Commission to intervene to protect the integrity of markets and the investors and shareholders of all publicly held companies.

John C. Whitehead, the recently retired leader of Goldman, Sachs & Co. is more pessimistic. In a speech on February 2, 1985, he said:

> If the New York Stock Exchange lowers its standards, I fear what has been called 'the race to bottom' will quickly occur, that all companies will move to whatever is the lowest common denominator that the Exchange will permit . . . that corporate democracy as we have known it will disappear.

The nub of the matter is simply this: as a matter of public policy, are there sufficiently compelling reasons to deny our great corporations the right to choose whether to unbundle the vote from publicly held common stock?

Among the many specific questions that should be addressed in this debate are the following:

- Is a two-class common with disproportionate voting rights too great a disservice to public shareholders to permit, unless they approve? Is the disservice so great that shareholders need protection, even against themselves?
- If shareholder approval validates the shift to two class common with disproportionate voting rights, what level of approval is needed, and how are the votes of management and other "interested" shareholders to be treated?
- Does the issue transcend the rights of shareholders, affecting the legitimacy of vesting so much of our nation's wealth and resources in the hands of self-perpetuating private bureaucracies?
- Legitimacy aside, is our entrepreneurially driven competitive system of product and service delivery likely to be weakened by allowing management to use this ultimate anti-takeover device, or will the system be strengthened by managements free (at last) to focus on the long-term?
- Will the marketplace function efficiently to penalize corporations that unbundle the vote and keep it for management, by increasing their cost of capital, thereby placing them at a significant disadvantage to their less insecure competitors? In this regard, what should we make of Ford Motor

Company, which went public in 1956 with 40% of the vote allocated to Class B common, then held tightly by the Ford family and so maintained ever since. Ford stock has not appeared to sell at a discount from comparable auto stocks on account of control being irrevocably lodged with the family.

- On the other hand, recent studies of the market effects of creating two classes of common stock with disproportionate voting rights show immediate and large wealth losses to outside stockholders. For example, Dow Jones' creation of two classes of common prompted a net-of-market stock price decline of 12%. When the Wall Street Journal reported Figgie International's decision to exchange low-vote, high dividend common for its outstanding common and impose a 15% voting limit on any shareholder, regardless of ownership, and the New York Stock Exchange's decision to de-list the company, a 17% net-of-market drop ensued.
- What role will the growing class of institutional investors play in this matter? Unlike the individual investor, they are informed, capable of organizing or being organized and possessed of increasing size and clout. Do they now, or will they in the future, constitute a marketplace

restraint on management's freedom to entrench itself? In this regard, the New York Stock Exchange estimates that about half the securities of some of its listed companies are held by institutions. In a survey of constituent groups conducted by the Exchange's Subcommittee on Shareholder Participation and Qualitative Listing Standards, 58% of those responding said the Exchange should not continue present shareholder participation requirements. However, only 23% of the institutional investors polled expressed that view.

Another straw in the wind is blowing from California. State Treasurer Jesse M. Unruh has realized his idea of forming a Council of Institutional Shareholders to oppose corporate actions considered contrary to the best interests of shareholders. Serving with him as Co-Chairmen, are John Konrad, Chairman of the Wisconsin State Investment Board, and Harrison J. Goldin, Comptroller for New York City. Council members, a majority of whom represent public pension funds, total 22 so far, with combined assets of more than $100 billion. There are today some $400 billion in U.S. public pension funds. Finally, a number of institutional investors have adopted

policies against shark repellents, including efforts to entrench management through two class common. Some simply sell their holdings when issuers turn to these measures, while others seek to block them.

- Are institutional investors hobbled by the securities laws (i.e., the various consequences of exercising "control") from organizing, individually or in groups, to assert a more effective supervisory role (as recently suggested by Professor Alfred E. Conard) of Michigan Law School?12/
- Is the issue merely a "tempest in a teapot", since long ago management assumed actual control, while leaving shareholders with only the symbol? Is this change but the coda to a process concluded years ago?

Concluding Thought

Regardless of how the question of the SEC's authority is resolved, it would constitute an exemplary act of public responsibility for that agency to hold public hearings on the issue of unbundling the vote. The public, the Congress, and other agencies of government, federal and state, could be invited to address the issue in its broadest dimensions. A report of the proceedings could

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12/ Conard, The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law, 82 Mich. L. R. 1459, 1473 (1984).

Senator D'AMATO. Mr. Macklin.

STATEMENT OF GORDON S. MACKLIN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. MACKLIN. Thank you, Mr. Chairman.

My name is Gordon Macklin. I am president of the National Association of Securities Dealers.

The NASD is registered with the Securities and Exchange Commission as a national securities association and its purpose is to provide for self-regulation of the over-the-counter securities market. In addition, the association maintains and operates the NASDAQ automated quotation system which is a computerized system by which NASD members exchange quotations for securities traded over the counter.

The purpose of this hearing is to focus upon the interests of shareholders in corporate takeovers including an examination of issues relating to listing standards, shareholder voting rights, and corporate governance requirements. We believe that any assessment by the Congress as to the feasibility or necessity of legislation in this area should be undertaken with the knowledge and understanding of the securities markets as they exist in 1985 and that U.S. securities markets are the most efficient and effectively regulated in the world.

FEARED RACE TO THE BOTTOM

There has in recent months been much comment, both in the press and in the governmental-regulatory community, about a feared race to the bottom among the securities marketplaces. Admittedly, there is more competition between the country's securities markets but we do not believe it to be inherently detrimental to the investing public. In fact, we believe there have been a number of public benefits that have resulted from this intermarket competition in the areas of automation, information, and market services to issuers. Somewhat as a result of this competition, the NASD has doubled its original NASDAQ criteria, materially raised the eligibility standards for companies to be included in our daily newspaper list and is in the process of strengthening NASDAQ/NMS requirements. Thus, intermarket competition may lead to a race to the top. At least, that's the race the NASD believes it's in.

In this same vein, there has recently been much discussion of the issue of unequal voting rights, that is, the issuance by a corporation of two classes of stock, one class of which has voting power superior to that of the other. As you are undoubtedly aware, requirements of the New York Stock Exchange, the American Stock Exchange, and NASDAQ are inconsistent on the subject. The NYSE currently prohibits any voting disparaties in classes of stock issued by its listed companies but a committee of its board has recommended the adoption of requirements which would generally compare with, though are not identical to, the Amex's requirements which prohibit a disparity in voting power greater than 10:1. Neither NASDAQ nor NASDAQ/NMS currently has voting rights provisions; however, as part of our continuing efforts to improve eligibility requirements, the NASD is in the midst of a survey on the

subject. In excess of 500 returns have already been received and are being analyzed and the completed questionnaires are still coming in. Also, the NASD has initiated a meeting with the chairmen of the New York and American Stock Exchanges to be held 2 days from now on June 14 at the NASD. The purpose of this meeting will be to discuss and examine in detail the whole voting rights issue and matters relating thereto. It is obviously too early to speculate on the outcome of these discussions, however, I feel certain all parties will be acting with the best interests of the public and the overall securities markets of the United States in mind.

NASDAQ SYSTEM

As you know, the NASDAQ national market system is a segment of the NASDAQ system containing high-quality companies. A profile of the almost 2,000 companies now traded on NASDAQ/NMS demonstrates that as of the end of 1984, the average price per share was in excess of $15. The average issuer had almost 8 million outstanding shares with a public float of 5.8 million shares and a market value in excess of $120 million. The companies in the system had average assets of over $570 million and equity in excess of $84 million. Their revenues averaged $181 million with net income of over $8 million. In addition, those companies on NASDAQ/NMS had an average of 10 market makers.

In addition to the voting rights issue, in the area of strengthened NASDAQ/NMS criteria, the association is presently considering adopting specific corporate governance requirements including independent directors and audit committees. If approved by the NASD Board at its July meeting, these proposals will be filed for SEC approval shortly thereafter. As part of the voting rights survey, the association is attempting to obtain empirical data with respect to the issue of shareholder approval for certain corporate actions. Based upon the results of this survey, the association will be in a position to determine an appropriate course of action.

The association believes that within the context of the NASDAQ system and, in particular, NASDAQ/NMS the interests and role of shareholders are being addressed. The association is interested, however, in exploring meaningful improvements to our market and stands ready to participate in further deliberations of the subcommittee or to provide you with any additional information which may be required.

[The complete prepared statement follows:]

TESTIMONY OF
GORDON S. MACKLIN, PRESIDENT
National Association of Securities Dealers, Inc.
before the
Subcommittee on Securities
of the
Committee on Banking, Housing and Urban Affairs
United States Senate

June 12, 1985

My name is Gordon S. Macklin and I am President of the National Association of Securities Dealers, Inc. (the "NASD"). The NASD is registered with the Securities and Exchange Commission as a national securities association pursuant to the provisions of the Maloney Act which was a 1938 Amendment to the Securities Exchange Act of 1934 and is the only Association so registered. The NASD's purpose is to provide for self-regulation of the over-the-counter securities market. It employs 1,100 people to achieve this end. At this time, the NASD has over 5,900 broker-dealer members employing over 330,000 sales persons and principals. It carries out its examination disciplinary and other regulatory responsibilities through its Washington headquarters and 14 district offices located in major cities throughout the country.

In addition, the Association operates two wholly-owned subsidiary corporations, NASDAQ, Inc. and NASD Market Services Inc. NASDAQ, Inc. maintains and operates the

NASDAQ Automated Quotation System. This system is a computerized system by which NASD members exchange quotations for securities traded over-the-counter. NASD Market Services enables NASD members to enhance their capabilities in the areas of transaction execution, trade reporting and clearance of transactions through the use of facilities offered by the Corporation.

Corporate Takeovers

The purpose of this hearing is to focus upon the interests of shareholders in corporate takeovers including an examination of issues relating to listing standards, shareholder voting rights and corporate governance requirements. The ultimate legislative policy determinations with respect to the proper role of corporate takeovers in the American economy are issues upon which the Association is not in a position to comment given its broad and diverse constitutency which includes broker-dealer members and the companies quoted in the NASDAQ System. As the organization which maintains the third largest and fastest growing equity securities market in the world, however, the Association believes that any assessment by the Congress as to the feasibility or necessity of legislation in this area should be undertaken with the knowledge and understanding of the securities markets as they exist in 1985. We believe the U.S. securities markets are the most efficient and effectively regulated in the world.

Notwithstanding that I do not believe that the NASD as an organization is properly equipped to discuss the intricacies of corporate takeover, hostile or otherwise, and defenses thereto, I would first like to address one issue which has received substantial publicity in recent weeks, that is, the issue of shareholder voting rights. This issue comes to the forefront because of action taken by certain corporations, as takeover defenses. Typically, this involves the issuance by a corporation of two classes of stock, one class of which has voting power superior to that of the other. As you are undoubtedly aware, the requirements of the New York Stock Exchange, the American Stock Exchange and NASDAQ are inconsistent on the subject. The NYSE currently prohibits any voting disparities in classes of stock issued by its listed companies but a Committee of its Board has recommended the adoption of requirements which would generally compare with, though are not identical to, the Amex's requirements which prohibit a disparity in voting power greater than 10:1. Neither NASDAQ nor NASDAQ/NMS currently has voting rights provisions; however, as part of our continuing efforts to improve eligibility requirements, the NASD is in the midst of a survey on the subject. In excess of 500 returns have already been received and are being analyzed and the completed questionnaires are still coming in. Also, the NASD has initiated a meeting with the Chairmen of the New

York and American Stock Exchanges to be held two days from now on June 14th at the NASD. The purpose of this meeting will be to discuss and examine in detail the whole voting rights issue and matters relating thereto. It is obviously too early to speculate on the outcome of these discussions, however, I feel certain all parties will be acting with the best interests of the public and the overall securities markets of the United States in mind. We will keep you informed of developments.

NASDAQ Criteria

Aside from the issue of voting rights, each of the leading securities markets has a unique set of criteria which determine the eligibility of securities for trading in that market.

There has in recent months been much comment, both in the press and in the governmental/regulatory community, about a feared "race to the bottom" among the securities marketplaces. Admittedly, there is a hightened degree of competition between the country's securities markets but we do not believe such competition is inherently detrimental to the investing public. Quite the contrary, we believe this competition is resulting in a review of criteria which may lead to the adoption of more stringent requirements and a "race to the top." At least, that is the race the Association feels it is in.

I would like to take this opportunity this morning to acquaint the Subcommittee both with the NASDAQ System and with certain proposed amendments to the eligibility criteria for inclusion in the NASDAQ National Market System (NASDAQ/NMS). Upon adoption, these criteria will impose a new group of corporate governance standards upon issuers having securities traded in the NASDAQ/NMS marketplace. These proposals are the antithesis of a "race to the bottom."

By way of background, however, the NASDAQ System, which came into existence in 1971 and NASDAQ/NMS which has been in place since 1982, are both logical extensions of the Association's historical function as a self-regulatory organization. NASDAQ had its genesis in the report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95 88th Cong. 1st Sess. (1963) which included a substantial discussion of the functioning of the over-the-counter markets and called for the use of automation in the over-the-counter markets. Following the Special Study, Congress acted to clarify the authority of the NASD in the Securities Acts Amendments of 1964 which amended the Exchange Act. These amendments provided that the NASD could not remain registered as a national securities association unless the SEC determined that its rules "promote orderly procedures for collecting, distributing and publishing quotations." Securities Exchange Act, Section 15A(b)(11).

Since its inception in 1971, the NASDAQ System has brought a major segment of the over-the-counter market from the point where available OTC quotations were primarily written and outdated when made available, with very little public visibility, to a point where NASDAQ comprises the second largest securities market in the United States. In 1984, its share volume was 66% of that of the New York Stock Exchange and almost 10 times that of the American Stock Exchange. Annual share volume for NASDAQ Securities stood at 15.2 billion shares in 1984 compared to 6.6 billion shares in 1980. The daily volume on NASDAQ reached a high of 122 million shares on August 3, 1984 and on several occasions has exceeded the daily share volume on the New York Stock Exchange. Dollar volume of trading has increased by in excess of 700% from $18.7 billion in 1974 to $153.4 billion in 1984. In terms of dollar volume, NASDAQ is third in the world behind the New York and Tokyo Stock Exchanges. Its dollar volume exceeds the aggregate volume of the next four exchanges worldwide. The aggregate market value of securities in NASDAQ totals $207 billion, an increase of more than 100% in the last five years. There are now in excess of 4,700 securities of approximately 4,100 companies quoted in the NASDAQ System with more than 120,000 quotation terminals around the world currently able to receive up-to-the-second quotations on NASDAQ securities. NASDAQ quotations are now carried, on a daily basis, by

over 150 newspapers throughout the United States. The number of NASDAQ companies has grown by 60% in the past five years.

The NASDAQ National Market System is a segment of the NASDAQ System wherein, from the standpoint of investors, securities are on a par with those securities listed on the major securities exchanges. Designation as a NASDAQ/NMS security is made pursuant to criteria set forth in a rule promulgated by the Securities and Exchange Commission and subject to change only through the SEC rulemaking process. Any such change must comport with the mandates of Congress as embodied in the 1975 Amendments to the Securities Exchange Act which created the concept of a national market system for securities transactions.

The Association believes that the listing criteria for NASDAQ/NMS are equal to and in some cases exceed the criteria for listing applied by the various securities exchanges. In fact, there are some 600 to 700 NASDAQ securities which meet the financial criteria for listing on the New York Stock Exchange and some 1,800 which would qualify for listing on the American Stock Exchange. NASDAQ/NMS designation provides investors with last sale trade and volume reporting similar to that found on the New York and American Stock Exchanges. In addition, to the information which trade reporting provides to the investing public, this information enables the NASD, through its market surveillance staff to more precisely monitor trading

activity with respect to NASDAQ/NMS issues. This additional surveillance enhances the Association's ability to detect unusual trading activity and to prevent or take action against manipulative or other improper activity in NASDAQ/NMS securities.

A profile of the almost 2,000 companies now traded on NASDAQ/NMS demonstrates that as of the end of 1984, the average price per share was in excess of $15. The average issuer had almost 8 million outstanding shares with a public float of 5.8 million shares and a market value in excess of $120 million. The companies in the system had average assets of over $570 million and equity in excess of $84 million. Their revenues averaged $181 million with net income of over $8 million. In addition, those companies on NASDAQ/NMS had an average of ten market makers.

NASDAQ Proposals on Corporate Governance

Beyond the quality of the NASDAQ marketplace and, in particular, the NASDAQ/NMS market and the securities traded therein, the Association is presently in the process of adopting specific corporate governance requirements on securities which are designated for inclusion in NASDAQ/NMS. The Association believes this to be an evolutionary step in the market which reflects the substantial changes brought about in the over-the-counter markets by development of NASDAQ.

The suggestion for developing corporate governance requirements came from the Association's Corporate Advisory Board which is composed of chief executives of prominent NASDAQ companies. A special subcommittee of that Board was constituted during the fall of 1984 to undertake an analysis of corporate governance principles and the possibility of adopting such standards for NASDAQ/NMS companies. A set of proposals was developed, presented to the Corporate Advisory Board and ultimately to the NASD Board of Governors. These provide corporate governance standards similar to those of the New York and American Stock Exchanges.

In March of this year, the NASD Board approved the proposals for distribution to NASD members and NASDAQ companies for comment. The comment period has recently concluded. In excess of 50 comments were received. These comments will be before the Corporate Advisory Board at its meeting tomorrow, June 13th, out of which final recommendations to the NASD's Board of Governors are anticipated. The recommendations of the Corporate Advisory Board will be presented to the NASD Board at its July 12, 1985, meeting for final approval. If accepted by the Board, a filing of the proposal for approval with the Securities and Exchange Commission will take place as soon thereafter as possible. The following is a summary of the corporate governance proposals. (A copy of the release requesting comment is submitted herewith).

Independent Directors -- The rules would require issuers to maintain a minimum of two independent directors on each company's board. "Independent director" is defined so as to exclude officers or employees of the company or its subsidiaries or any other individual having a relationship which the Board believes would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Audit Committees -- The rules require an issuer to establish and maintain an audit committee, a majority of the members of which shall be independent directors.

Distribution of Annual and Interim Reports -- The rules would require issuers to distribute both annual and interim reports to shareholders. Annual reports would be required to be distributed "a reasonable period of time prior to the company's annual meeting" whereas interim reports would be distributed "within a reasonable time" following filing of required interim financial reports with the SEC or other regulatory authority. For companies required to file Form 10-Q with the SEC, quarterly reports to shareholders would be required. Other companies would be required to provide shareholders with reports reflecting information contained in interim financial reports filed with their appropriate regulatory authority.

Shareholder Meetings -- Companies would be required to hold an annual meeting of shareholders.

Quorum -- The rules would require companies to establish a quorum requirement of at least 50% of the outstanding shares for all meetings of the holders of common stock.

Solicitation of Proxies -- Issuers would be required to solicit proxies and distribute proxy statements for all meetings of shareholders and to file copies of proxy solicitations with the NASD.

Conflicts of Interest -- The rules would address situations in which companies may have a conflict of interest in transactions with persons related to the company. The rules would require that companies conduct "an appropriate review" of all related party transactions on an on-going basis and that the audit committee be utilized to review potential conflicts where appropriate.

Listing Agreement -- The rules would require each NASDAQ/NMS issuer to execute a listing agreement as prescribed by the NASD.

It can be seen from the foregoing that implementation of these standards will require NASDAQ/NMS issuers to provide for substantial shareholder involvement in corporate affairs and provide them with information on corporate activities to enable them to meaningfully participate in corporate affairs.

Beyond the areas covered by these proposals, the Association is currently undertaking a survey of NASDAQ companies to develop information about two other aspects of

corporate governance. One of these issues I discussed earlier, that of shareholders' voting rights., This study also encompasses the area of shareholders' rights to approve specified corporate transactions. Given the wide range of views which exist with respect to the voting rights issue in particular, the Association did not believe it would be appropriate to take any action in this area without first obtaining sufficent empirical data upon which to undertake a meaningful analysis of the scope and nature of voting rights provisions which exist among issuers in the NASDAQ system. The survey, which is currently underway, is designed to elicit information from NASDAQ issuers relating both to voting rights and to the various types of transactions which require shareholder approval. With respect to voting rights the survey seeks information such as the number of classes of stock traded; the voting rights of the classes; the types of transactions on which limitations apply and other types of limitations which may exist among the issuers represented in the system. The survey also seeks information on the type and size of corporate transactions which require shareholder approval. (A copy of this survey is being provided to the Committee herewith).

The Association believes, at least in the context of the NASDAQ system and, in particular NASDAQ/NMS wherein 50% of all NASDAQ trading takes place, that the interests and the role of shareholders are being addressed. However, we are continuously interested in exploring meaningful improvements to our market and we stand ready to participate in further deliberations of the Subcommittee or to provide any additional information which you may require.

NASD

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

May 13, 1985

TO: All NASDAQ Companies

RE: Survey on Certain Corporate Governance Issues

At the recommendation of the Corporate Advisory Board, the Board of Governors of the National Association of Securities Dealers, Inc., is requesting all NASDAQ companies to participate in a survey on two corporate governance issues: voting rights of various classes of stock and possible restrictions on the issuance of shares in connection with changes in control of NASDAQ companies. The Corporate Advisory Board will use this information to guide it in formulating corporate governance provisions in these areas for NASDAQ National Market System (NASDAQ/NMS) securities.

In a Notice to NASDAQ Companies dated March 28, 1985, the NASD requested comments on proposed rules which would require NASDAQ/NMS companies to comply with certain standards of corporate governance. The proposed rules were the product of many months of work by the Corporate Advisory Board. The Corporate Advisory Board consists principally of the chief executive officers of NASDAQ companies who advise the NASD Board of Governors on matters affecting the operation and regulation of the NASDAQ market.

The first part of the survey concerns voting rights. It should be noted that the NASD is not at this time proposing to restrict the voting rights assigned to various classes of stock issued by NASDAQ/NMS companies. The Corporate Advisory Board is aware that the issue of voting rights is currently under review by various government and state agencies as well as other regulatory organizations. At least two congressional committees, the New York Stock Exchange and the California Corporations Department are conducting reviews of policies on voting rights. In this environment, it was concluded that the Association should survey NASDAQ companies on this important issue.

The second part of the survey addresses possible restrictions on a corporation's issuance of stock in connection with a change of control. Certain exchanges restrict the percentage of new shares which a company may issue without shareholder approval. In view of the multiplicity of issues related to such restrictions and the continuing evolution of practices concerning mergers and acquisitions, it was concluded that the Association should obtain more information with respect to NASDAQ companies prior to developing specific rule proposals on this question.

The enclosed survey is intended to provide quantitative information on NASDAQ companies to the Corporate Advisory Board during its review of these two aspects of corporate governance. The Corporate Advisory Board believes that the likelihood of achieving a "blue-sky" exemption for NASDAQ/NMS companies in all 50 states will be greatly improved by the implementation of corporate governance criteria. The NASD Board of Governors and the Corporate Advisory Board request your assistance in our effort to collect information on existing voting rights and change of control provisions for all NASDAQ companies through the completion of the enclosed survey.

Any questions regarding the survey should be directed to Dennis C. Hensley or T. Grant Callery at (202) 728-8294.

Sincerely,

Gordon S. Macklin
President

Enclosure

NASDAQ COMPANY SURVEY

Please answer the following questions and return the completed survey in the attached envelope to Glenn C. Faulkner, 1735 K Street, N.W., Washington, D.C. 20006. Questions relating to the survey should be directed to T. Grant Callery at (202) 728-8294.

PART I. VOTING RIGHTS

1. Does your company have multiple classes of stock?

   Yes ☐ No ☐

2. If your company has multiple classes of stock, are all classes publicly traded?

   Yes ☐ No ☐

3. Do all classes of stock carry voting rights?

   Yes ☐ No ☐

4. Are voting rights for all classes of stock "one share/one vote"?

   Yes ☐ No ☐

5. List below the number and the voting rights per share for each class of stock:

	Description Of Class Of Stock	Total Shares Authorized	Total Shares Issued And Outstanding	Voting Rights For Each Share Of Stock
i.	_____	_____	_____	_____
ii.	_____	_____	_____	_____
iii.	_____	_____	_____	_____
iv.	_____	_____	_____	_____
v.	_____	_____	_____	_____

6. Other than the possibility for disparity in voting power (i.e., classes of stock with more or less than one vote per share), do any other restrictions or preferences apply to any class of stock?

Yes ☐ No ☐

7. If the answer to Question 6 is yes, do these restrictions or preferences involve:

A. Dividends?

Yes ☐ No ☐

B. Election of less than the full Board of Directors?

Yes ☐ No ☐

C. Requirement to vote shares in person (limited or no proxy authority)?

Yes ☐ No ☐

D. Declining voting power as a result of concentrated stock holdings?

Yes ☐ No ☐

E. Other limitations not covered in Questions A through D above? (Please explain below.)

_____

_____

_____

_____

_____

_____

_____

_____

_____

8. If your company has classes of common stock with differing voting rights, does the junior class have the right to elect a set percentage of the Board of Directors?

Yes ☐ No ☐

A. If yes, what percentage?

_____ percent

B. Does the percentage set forth in Question 8A change if the number of shares outstanding of the senior class of securities falls below a specified level?

Yes ☐ No ☐

C. If so, what level?

_____

PART II. CHANGE OF CONTROL PROVISION

1. Is shareholder approval required for any transaction involving the sale or issuance of the company's stock?

Yes ☐ No ☐

2. If yes,

A. Is there a minimum percentage of the outstanding shares below which such approval is not required? Please indicate that percentage:

_____ percent

B. Please describe the transactions for which such approval is required.

_____

_____

_____

_____

3. Is shareholder approval required for the issuance of shares in connection with the grant of any options or other special remuneration plans to officers, directors or key employees?

Yes ☐ No ☐

4. Please indicate the percentage of shareholder approval that is required for the transactions described in Questions 1 through 3 of this Part II.

_____

_____

_____

_____

_____

_____

_____

_____

_____
Signature of Survey Respondent

_____
Name and Title of Survey Respondent

_____
Name of NASDAQ Company

THANK YOU FOR TAKING TIME TO COMPLETE THIS SURVEY.

NASD

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

March 28, 1985

TO: All NASDAQ Companies

RE: Request for Comment on Proposed Corporate Governance Requirements for NASDAQ National Market System Companies

LAST DATE FOR COMMENT: APRIL 28, 1985

The National Association of Securities Dealers, Inc., is requesting comment on proposed rule amendments which would require that companies with securities included in the NASDAQ National Market System (NASDAQ/NMS) adhere to certain standards of corporate governance. This notice contains a discussion of the background of these rules and a section-by-section analysis. The text of the proposed rules is attached.

HISTORY AND BACKGROUND

The publication of the proposed rules is a result of an effort of several months by the NASD Corporate Advisory Board. The Corporate Advisory Board is a body consisting principally of the chief executive officers of NASDAQ companies, chaired by Wilson C. Wearn, Chairman and Chief Executive Officer of Multimedia, Inc., which reports to the NASD Board of Governors. The Advisory Board has played an important role in the evolution of NASDAQ as the fastest-growing and second-largest securities market in the United States, and in the development of NASDAQ/NMS.

Since its inception in 1982, NASDAQ/NMS has grown steadily in size and stature. In November 1984, the Securities and Exchange Commission approved a change to NASDAQ/NMS inclusion criteria which has resulted in a further enhancement in the quality of NASDAQ/NMS companies. As of the end of 1984, the average NASDAQ/NMS company had assets of over $570 million and equity in excess of $84 million. Their revenues averaged $181 million with net income of over $8 million. The average price per share for NASDAQ/NMS issues was in excess of $15 and the average issue had almost 8 million shares outstanding with a public float of 5.8 million shares and a market value in excess of $120 million. NASDAQ/NMS issues had an average of 11.5 market makers in the system.

As NASDAQ/NMS has matured, the Corporate Advisory Board has come to believe that it is appropriate to consider the quality of corporate governance of NASDAQ/NMS companies. This concern has been heightened by numerous state

securities administrators who have noted the differences in approach to corporate governance by NASDAQ/NMS and certain of the exchanges. The Corporate Advisory Board believes that the likelihood of achieving a "blue-sky" exemption for NASDAQ/NMS companies in all 50 states will be greatly improved by the implementation of corporate governance criteria.

A special subcommittee of the Corporate Advisory Board chaired by B. Lee Karns, President and Chief Executive Officer of Comprehensive Care Corporation, devoted considerable time during the fall of 1984 to an analysis of corporate governance principles and the propriety of adopting corporate governance standards for NASDAQ/NMS. In January, the subcommittee reported its conclusions to the Corporate Advisory Board and recommended that numerous corporate governance rules be proposed for NASDAQ/NMS and that a survey be conducted of NASDAQ companies concerning additional aspects of corporate governance.

After careful consideration, the Corporate Advisory Board accepted the subcommittee's recommendations and in turn recommended to the NASD Board of Governors that the following corporate governance rules be proposed and that a survey on other possible rules be conducted. The NASD Board of Governors concurred in these recommendations.

SUMMARY OF PROPOSED RULES

The proposed rules, as drafted, would be added to Schedule D to the NASD By-Laws and would become additional criteria for eligibility in NASDAQ/NMS. The rules contain requirements generally similar to those of the New York Stock Exchange and the American Stock Exchange. The proposed rules are summarized below. The text of the rules appears as Exhibit A.

Applicability — The rules would apply to any issuer with a security traded in the NASDAQ/NMS market.

Eligibility — The Corporate Advisory Board contemplates that compliance with the corporate governance rules would be a requirement for a company to be eligible for continued inclusion in NASDAQ/NMS. 1/

Distribution of Annual and Interim Reports — The rules would require issuers to distribute both annual and interim reports to shareholders. Annual reports will be required to be distributed within "a reasonable period of time prior to the company's annual meeting," whereas interim reports would be distributed "within a reasonable time" following filing of required interim financial reports with the SEC or other regulatory authority. For companies required to file Form 10-Q with the SEC, quarterly reports to shareholders (on Form 10-Q or otherwise) would be required. Other companies would be required to provide shareholders with reports reflecting information contained in interim financial reports filed with the appropriate regulatory body.

Independent Directors — The rules would require issuers to maintain a minimum of two independent directors on each company's board. "Independent

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1/ This approach is discussed further on in connection with sanctions.

director" is defined so as to exclude officers or employees of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The determination of independence of any particular director would therefore be left to the judgment of each company's board.

Audit Committees — The rules require an issuer to establish and maintain an audit committee, a majority of the members of which shall be independent directors.

Shareholder Meetings — Companies will be required to hold an annual meeting of shareholders.

Quorum — The rules would require companies to establish a quorum requirement of at least 50% of the outstanding shares for any meeting of the holders of common stock.

Solicitation of Proxies — Issuers would be required to solicit proxies and distribute proxy statements for all meetings of shareholders and file copies of proxy solicitations with the NASD.

Conflicts of Interest — The rules would address situations in which companies may have a conflict of interest in transactions with persons related to the company. The rules would require that companies conduct "an appropriate review" of all related party transactions on an ongoing basis and that the audit committee be utilized for the review of potential conflicts where appropriate.

Listing Agreement — As drafted, the rules would require each NASDAQ/NMS issuer to execute a listing agreement as prescribed by the NASD. A listing agreement would establish a contractual relationship between each issuer and the NASD.

Effective Date — The rules provide a 12-month "grandfather" period for any NASDAQ/NMS issuer in the system at the time the rules are approved. They would immediately apply to all companies entering the system after they became effective. In addition, the effectiveness of the rules could be delayed for securities entering the system until some reasonable period following approval of the rules.

In view of the fact that some companies may be required to change their corporate charters, comments are specifically requested with respect to the issues of grandfathering and an appropriate phase-in period for the rules.

SANCTIONS FOR NON-COMPLIANCE

The Corporate Advisory Board believes that the appropriate sanction for a NASDAQ/NMS company which fails to meet corporate governance criteria should be deleted from NASDAQ/NMS. Under such an approach, companies deleted from NASDAQ/NMS would remain in NASDAQ. Under present SEC rules, however, any NASDAQ security meeting Tier 1 criteria is mandated to be included in NASDAQ/NMS and cannot be deleted from NASDAQ/NMS while remaining in NASDAQ. The NASD is submitting Section 2 of the proposed rules for comment with the expectation that these rules will be amended.

SURVEY ON VOTING RIGHTS AND CHANGE OF CORPORATE CONTROL

As noted above, the NASD Board of Governors has also approved a survey of NASDAQ companies on two other aspects of corporate governance. That survey will be sent to all NASDAQ companies in the near future.

The first topic addressed by the survey concerns voting rights. The NASD is not proposing at this time to restrict the voting rights assigned to various classes of stock issued by NASDAQ/NMS companies. As the question of voting rights has assumed greater importance in recent years, the New York Stock Exchange has undertaken a review of its policies in this area. The California Corporations Department is also conducting a review of that state's policies on voting rights. In this environment, it was concluded that the Association should survey NASDAQ companies to determine their views on this important issue.

The second matter included in the survey concerns possible restrictions on a corporation's issuance of stock in connection with a change of control. Certain exchanges restrict the percentage of new shares which a company may issue without shareholder approval. In view of the multiplicity of issues related to such restrictions and the continuing evolution of practices concerning mergers and acquisitions, it was concluded that the Association should obtain more information with respect to NASDAQ companies' views prior to developing specific rule proposals on this question.

NASDAQ companies are urged to review the survey carefully when it is received and return it to the Association with a complete expression of their views.

REQUEST FOR COMMENTS

The Association is requesting comments on the proposed rules prior to final Board consideration. All comments received during this comment period will be reviewed by the Corporate Advisory Board and changes will be recommended as deemed appropriate. The Board of Governors will then reconsider the proposal. If the Board approves the rules or an amended version, they must be filed with, and approved by, the Securities and Exchange Commission before becoming effective.

All written comments should be addressed to:

James M. Cangiano, Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

All comments must be received by April 28, 1985. Any questions regarding this notice should be directed to either Dennis C. Hensley or T. Grant Callery at (202) 728-8294.

Sincerely,

Gordon S. Macklin
President

Attachment

Exhibit A

DRAFT CORPORATE GOVERNANCE PROVISIONS
AS APPROVED BY THE CORPORATE ADVISORY BOARD

Add new Part II D to Schedule D to the NASD By-Laws as follows; existing sections D and E to be redesignated as E and F respectively.

D. Rules for Issuers of NASDAQ National Market System Securities

1. Applicability

   a. This Part II D shall apply to any NASD/NMS issuer.

   b. For purposes of this Part II D, "NASDAQ/NMS issuer" shall mean the issuer of a security included in the NASDAQ System which has been designated as a national market system security pursuant to Rule 11Aa2-1 under the Securites Exchange Act of 1934.

2. Eligibility

   No security shall be eligible for inclusion in the NASDAQ National Market System unless the issuer of said security is in compliance with this Part II D.

3. Distribution of Annual and Interim Reports

   a. Each NASDAQ/NMS issuer shall distribute to shareholders copies of an annual report containing audited financial statements of the company and its subsidiaries. The report shall be distributed to shareholders a reasonable period of time prior to the company's annual meeting of shareholders and shall be filed with the Corporation at the time it is distributed to shareholders.

   b. (i) Each NASDAQ/NMS issuer which is subject to SEC Rule 13a-13 shall distribute copies of quarterly reports including statements of operating results and financial position to shareholders within a reasonable time following the company's filing of Form 10-Q with the Securities and Exchange Commission. If the form of such quarterly report differs from Form 10-Q, copies of the report shall also be provided to the Corporation. The financial statements contained in quarterly reports shall be prepared in a manner consistent with generally accepted accounting principles but are not required to be audited.

   (ii) Each NASDAQ/NMS issuer which is not subject to SEC Rule 13a-13 and which is required to file on a periodic basis with the Securities and Exchange Commission, or another federal or state regulatory authority reports relating primarily to operations and financial position shall distribute to shareholders reports which reflect the information contained in such interim reports. Such reports shall be distributed to shareholders within a reasonable period of time following filing with the appropriate regulatory authority. If the form

of the interim report provided to shareholders differs from that filed with the regulatory authority, copies of such report shall also be provided to the Corporation.

4. Independent Directors

Each NASDAQ/NMS issuer shall maintain a minimum of two independent directors on its board of directors. For purposes of this section, "independent director" shall mean a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

5. Audit Committee

Each NASDAQ/NMS issuer shall establish and maintain an Audit Committee, a majority of the members of which shall be independent directors.

6. Shareholders Meetings

Each NASDAQ/NMS issuer shall hold an annual meeting of shareholders and shall provide notice of such meeting to the Corporation.

7. Quorum

Each NASDAQ/NMS issuer shall provide in its by-laws for a quorum for any meeting of the holders of common stock of at least 50% of the outstanding shares of the company's common voting stock.

8. Solicitation of Proxies

Each NASDAQ/NMS issuer shall solicit proxies and provide proxy statements for all meetings of shareholders and shall provide copies of such proxy solicitation to the Corporation.

9. Conflicts of Interest

Each NASDAQ/NMS issuer shall conduct an appropriate review of all related party transactions on an ongoing basis and shall utilize the company's Audit Committee as a forum for the review of potential conflict of interest situations where appropriate.

10. Listing Agreement

Each NASDAQ/NMS issuer shall execute a Listing Agreement in the form designated by the Corporation.

11. Effective Date

This Part II D shall apply to any issuer which first has a security designated as a national market system security after _____, and shall become effective as to any other NASDAQ/NMS issuer on [twelve months after approval].

Senator D'AMATO. Thank you very much, Mr. Macklin. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

As I listen to your testimony, gentlemen, I am a little confused as to how you stand on one-man one-vote action by the Congress to mandate that kind of change.

I see that in your conclusion, Mr. Phelan, you say, on page 14:

> Over the years, the one-share one-vote policy has served the market well. Philosophically, the exchange still believes in it. In an ideal world, most people would probably want it to be retained. But

you say,

> The world is changing very rapidly and the issue transcends the New York Stock Exchange.

You go on to say:

> The changes in the competitive environment have brought the issue to prominence are national in scope. And the national competitive environment may very well preclude the change from unilaterally retaining one share one vote,

which you have.

I am a little bit uncertain as to whether or not you feel the Congress should act to mandate this.

ADOPT ONE SHARE ONE VOTE

Mr. PHELAN. Well, I think if I had my choice the best course would be that Mr. Levitt at his next board meeting propose that the American Stock Exchange adopt as a listing standard one share one vote, and if he's worried about losing some companies, he should grandfather those companies that are in there already.

And that Mr. Macklin, as soon as he is finished with his survey, and when he has his board meeting propose one share, one vote, at least in tier 1 of the NASDAQ system, which I think includes at least 600 companies.

Failing that, I suppose the next best course would be for the Commission to review this at some point in time. I don't know whether they have the power to or not, but possibly they could address the problem in some way.

Indeed, if the exchanges and the NASD don't agree to changing their list standards one can never predict what out Board will do. We have a lot of people on our Board that serve on other boards of corporations all over the United States and the world, and there is a growing feeling that more and more corporations are considering issuing two classes of voting stock that are disproportionate in some way. Our board may then decide to send to the SEC a rule change on this matter. In some way or another, the Commission will have to address that rule change.

If it can't address it in some way, I suppose the third fallback position would be legislation. If, in fact, the Congress felt that it was in the national interest to have legislation to make sure that in the trading of significant corporations in this country that one share one vote is a doctrine that should be in the national interest.

Senator PROXMIRE. Are you suggesting we go a little slow on this, at least to give you an opportunity—the three of you and your or-

ganizations, to get together to determine whether or not you can agree?

Second, fallback would be the SEC, I understand, the Securities and Exchange Commission, and if there is no action there, then do you think we might very well see to considering at least a legislative mandate; is that right.

Mr. PHELAN. I think that would be the processes that I would suggest.

Senator PROXMIRE. Mr. Levitt, would this be acceptable to you?

You do say on page 13:

> We believe that the New York Stock Exchange's proposed response to these pressures is the wrong one. To respond to takeover fears by fundamental alteration of the machinery of corporate democracy is extremely risky.

I'm not sure if by that you mean that the Congress shouldn't go ahead either, because then we, of course, would be responding in a very comprehensive way to corporate democracy, changing the rules in a significant way, if we proceed.

Do I misinterpret that?

Mr. LEVITT. Well, I amended my testimony this morning in response to the chairman's proposed introduction of legislation, to say that I oppose this. I really view legislation as a last ditch alternative. I think we have the means available to us to cure the problem.

What concerns me about all of this is that it is a kind of a sleeping giant. If the New York Stock Exchange does, indeed, do this, and if we are obliged to respond from the standpoint of competitive pressure, I believe then the kind of legislation that might result ultimately—when it is recognized that a vast segment of corporate America has disenfranchised its shareholders—we are not talking about one company. Mr. Phelan, I believe, has said at one point that several hundred companies might follow suit.

If that occurs, I think the kind of legislation we might then expect would not just relate to one share one vote. It would relate to exactly what corporations must do, in terms of the Federal chartering of corporations—Who should be on the boards and which constituencies should they represent? And I think that's a very dangerous path to begin on.

I believe that the three institutions that sit before you today have the will to resolve the issue and I think if, for one reason or another, they are not able to, there is no question in my mind that the SEC and its Chairman can get the right resolution of the issue.

Senator PROXMIRE. You have more faith than I have in the dynamism and the energy of the SEC in that connection. I hope you're right.

Mr. LEVITT. I don't have faith, necessarily, but what I am saying is, I believe they have the power to do it, if they so choose, and I think that is another area of your involvement. That is another form of legislation that you could consider.

Senator D'AMATO. I'm wondering if my distinguished friend and colleague would yield for just a moment for an observation.

I withstood introducing this legislative initiative. Senator Metzenbaum and I have spoken about it. Congressman Dingell and I and our staffs have met. As a matter of fact, we met with the

Chairman of the SEC several weeks ago at Congressman Dingell's office. I have spoken to Mr. Levitt and Mr. Phelan.

I haven't spoken to Mr. Macklin. I will be very candid, Mr. Macklin. It is no accident that I announce that I am introducing this legislation tomorrow. I am very much aware of the meeting that the three exchanges will be having.

Is it an inducement to let you know that we are serious about this, and that there was a growing feeling of concern within the Congress as a body, across political lines? Yes, absolutely. Is it leverage? Yes, absolutely, because I have watched the kind of situation emerge—I'm not talking about any of the three of you or the groups you represent—where people are talking and talking and conferring and conferring and studying and studying. I watch that.

I have done a little bit of that myself. And where the SEC has studied studies, and that's not your governors, that's theirs, and I see a reluctant Chairman, and I understand why, and I spoke to him again last evening at 6:30 before I finally decided I was going to do this and tell him.

And certainly, if the three exchanges can come to an agreement that deals with that issue, in terms of the protection of voting rights for the shareholders, this Senator would be delighted.

I don't have great faith in the SEC moving on this issue. I don't, for all manner of reasons which I will not go into.

FINAL ANALYSIS MAY BE CONGRESS

Having said that, I do think you have made a terrible mistake to underestimate the speed in which this legislative initiative, I believe, will be accomplished in both Houses, if Congress sees that this is just a study and a means by which to put off dealing with this problem by the private sector, and if the regulators don't do it, then the final analysis will be Congress.

So these are the reasons that Senator Proxmire and the Senator from New York, the Senator from Ohio, Senator Cranston, have moved—and I think it has not been a rush to judgment on this, and we certainly hope that it is a catalyst which brings about some voluntary constraints in this area.

Senator PROXMIRE. I take it, Mr. Macklin, that one of the reasons why you're meeting on Friday is so you can work this out on a voluntary regulatory basis, and that you appreciate the sincerity and determination of the chairman.

And I can tell you, he is a very determined and very, very effective Senator, and if you folks don't find some way of meeting this problem in a way that is generally accepted, I expect that he is right, you will have that.

I am not sure how I will vote on it. I may vote for it, but a great deal depends on what you can do on Friday.

Mr. MACKLIN. Well, prior to calling a meeting, our chairman and I spent a considerable amount of time thinking about this subject. What research we have done, which is still in process, tells us that there are a lot of complexities. There's a lot of appeal, to one vote per share, but there are a number of complexities, and we feel that the expertise of the private sector would be very useful in trying to address the complexities and build an answer around those.

If that fails, I agree with Mr. Phelan that there is a lot of expertise at the Commission that could or should be brought to focus on this subject, and through that process, if all fails and it comes back to you for legislation, you will have a good bit of what's currently missing on this subject. That is the due process and the input and the gathering of facts and identifying the problems which are so necessary to come up to an ideal answer.

So that is why we're trying to work in this direction.

Senator PROXMIRE. Let me just say, sometimes we have to move ahead in these areas, although I would think at least two of you—maybe all of you have mentioned the fact, and I certainly feel very strongly that we have the best capital markets in the world. We have, over the years, had a superb administration by the SEC, and it is probably the best agency in Washington. They're honest, and the disclosures are very useful, and it has the support of people in this country, and as I say, everywhere.

We want to keep them that way, and I think you gentlemen have done a marvelous job in that way.

This Senator wouldn't want to butt in to change a situation, unless we have a real reason to do so, but I am concerned, as I am sure the chairman and others are concerned, at what is happening now with the takeovers and with the distortion of real democracy by our stockholders.

Beg your pardon. I have been taking too much time. I'll come back later with more questions.

Senator D'AMATO. Senator Riegle and then Senator Metzenbaum.

Senator RIEGLE. Thank you, Mr. Chairman.

I gather then, if I'm hearing it correctly, that all of you would prefer to—if you can—sit down together and work things out, that that is your first choice, that the markets themselves develop a satisfactory self-regulatory mechanism here; that if that can't be done directly, then the SEC ought to help you do it, and that if that fails, then as a last resort and only as a last resort, should legislation be considered.

Am I hearing all of you say that? Is that a proper summary, Mr. Phelan, of your view?

Mr. PHELAN. Yes; it is.

Senator RIEGLE. Mr. Levitt?

Mr. LEVITT. Yes.

Senator RIEGLE. Mr. Macklin?

Mr. MACKLIN. Yes; it is.

Senator RIEGLE. Now, let me ask you this. Of course, this gets very simple if when you meet on Friday and answers are found and everything is settled. If that doesn't happen, I'm just wondering what steps you would then envision in terms of the regulatory agency being involved? How should we sort of think through the question of how that process ought to go forward if we find ourselves at that point? I'd like the thoughts of each of the three of you on that.

ONE-THIRD OF THE PROBLEM ALREADY SOLVED

Mr. PHELAN. Senator, I think to begin with we already have one-third of the problem solved because we already have the rule in

place. I don't know what the discussion is going to be about and how complex the issue is aside from the fact that if the other two gentlemen in their marketplace really feel that it is in the national interest and the interest of shareholders to have one share, one vote, there is an easy resolution to their problem.

If, for whatever reason, the other two markets do not agree to that, then we may have at least a rule change to go down to the Commission so that they can take up the issue. At that point in time they will probably have to deal with that rule change in one way or another, either to say they have no jurisdiction over it or to approve it or to disapprove it in some way.

Senator RIEGLE. Would either of the other two gentlemen like to comment on that?

Mr. LEVITT. I think the Commission is reluctant thus far to address the issue, as the chairman has noted, due to a variety of factors, one of which is its concept of what its jurisdiction might be. I believe that this goes beyond that. I think that there are lots of ways they can approach this issue which don't even relate to that question.

Another way the Congress can address the question is to legislate the Commission's and make it clear they have that responsibility to see to it that these institutions act in the way that I think all of us agree we should be acting. Then you might not get entangled in the kinds of crosscurrents that would be involved in a purely legislative approach, without analyzing the various dislocations that that might create. That's just another way you can accomplish the same end, but I think there's a lot of interest in doing it.

Senator RIEGLE. Mr. Macklin.

Mr. MACKLIN. I'm not a lawyer and I consequently would not be an ultimate authority on the Commission's power.

As John Phelan said, this issue will get in front of them in a very prompt and orderly way if our discussions fail through the New York Stock Exchange filing a rule change. They could also pick it up on their own initiative. I do believe that through a combination of their legal powers and other leverage the Commission can impose on all of us market centers just about anything they can defend in the public interest.

We think there is ample authority and ample ability to achieve whatever they set out to do. We believe there is more than one way to put it on a Commission calendar in relatively short order.

Senator RIEGLE. Now, you have all mentioned the fact that there are some real complexities involved in sorting out all of the questions that relate to this subject. If we find that we can't sort the thing out with yourselves or with the SEC, and we've got legislation now being offered by the chairman and being offered on a bipartisan basis, and when that legislation is introduced tomorrow, I would assume in due course if the issue is not resolved there would be hearings held here.

I'm just wondering, Mr. Phelan, you have said in reviewing the issue of listing requirements, you're quote was "All interested parties must take a very hard look at some very tough questions to which the answers are not at all clear." It sounds reasonable to me, but I'm wondering who are some of these interested parties that you think would have to come in and offer their views if we get to

the point of hearings on this subject? Who do you think ought to be at the witness table to reflect on some of these questions?

Mr. PHELAN. Well, first of all I think that we should separate our one share, one vote, from mergers, takeovers, and other things. I think this is an entirely different subject. Sometimes they're linked together but they should not be. The problem that we are getting into is that these are defensive measures taken by corporations. I think one share, one vote, at least for myself is very simple and uncomplicated.

Senator RIEGLE. Well, let's say we limit it to that then. Who might we call on as interested parties to reflect on some of the complexities of that issue?

Mr. PHELAN. I suppose our organization is as good as any if we count all our constituencies which are member firms, listed companies, and potential listed companies, institution and individual shareholders. And the Congress itself, through these hearings has certainly expressed its interest. I think some spread over all of those people would have to be touched on.

Senator RIEGLE. Would the others of you agree with that? Would you add anybody else to that list?

Mr. MACKLIN. I would urge you to have the broadest list possible. We can tell from the questionnaires that we are receiving daily that it is not a homogeneous universe of companies out there; they're heterogeneous, with different needs, different backgrounds, different views, and we would urge you to have a large and diversified spectrum of companies. We'd also of course urge you to bring in representatives of our association, State officials, venture capitalists, different types of investors and, in light of the internationalization of markets, I would urge you to invite foreign companies.

Senator D'AMATO. Mr. Macklin, if I might, and my colleague would yield, let me tell you how I view this thing.

PASS TO THE SEC

My picture. I have watched you work. We have talked to the SEC. What I hear is everyone says we'll do it, we want to do it, but we really don't think we're going to do it and we're going to look to the SEC. I say that after reviewing your testimony. Some of your remarks are just about what you said, Mr. Macklin. I don't think they'll do anything Friday.

Mr. MACKLIN. Well——

Senator D'AMATO. All right, let's wait and see. I hope I'm wrong. But that's the sense I have of it because otherwise what are you talking about the SEC has the ability to do it? Now, we go back and let's look at the SEC. I don't say this again from a position of a person who hasn't been there and hasn't talked to the chairman and hasn't talked to some of the other Commissioners.

Congressman Dingell and I brought them in a couple of weeks ago. I spoke to them last night. Let me tell you what's going to happen there. Nothing. You know that. Let me tell you, you are the regulating organizations. You are abdicating, I would suggest, your responsibility if you say we're going to leave it to the SEC. It's a copout; it's the easy way out. It's a good way out, too, if you

really don't want to move to the area. Let me tell you why it's a good way.

You don't have to deal with the companies and the people and the corporate governance at issue. You say, oh, the SEC did it, so you're hoping that that will be a fallback that we're going to buy here.

I'm going to tell you something else. You think I'm going to have a lot of hearings here? This has been going on with respect to this mergers and acquisitions. I don't think it's that complicated an area.

We're going to look for the first vehicle coming through that's not going to be subject to presidential veto and we're going to hook it on. We're going to secularize this. We're going to meet with our constituents; we're going to listen to them.

I have heard the Business Roundtable come up here and say it was for one man, one vote. I have heard people who are at corporate governance say I'm for it. So just let me suggest to you that that may be oversimplifying it, but that's the way I see it. That's the way I see it coming down.

Senator RIEGLE. Mr. Chairman, could I just ask one followup? I'm just wondering, Mr. Levitt, is there any complexity also that you'd like to sort of add to the list here or suggestions you would like to make that you admitted in that discussion?

Mr. LEVITT. No; I think there are all kinds of complexities, obviously, but I think this issue is so overriding and so compellingly in the national interest and so clearly in the interest of the institutions that sit before you, that it would be kind of tragic if we couldn't come to an agreement on it.

Senator RIEGLE. Thank you.

That's all from me, Mr. Chairman.

Senator METZENBAUM. Gentlemen, this is not a new issue for us. It's not a new issue for you. It's been before the committee 1 year ago, when we came back about 6 months ago, and I don't think there's anybody in the 535 Members of Congress who would not agree with what you said Mr. Phelan, and that is this issue can better be resolved by those affected themselves. You can resolve it.

It wasn't just happenstance that the chairman and I joined together—with the chairman from the House, Congressman Dingell, to introduce this bill at this point. We are sending a message. We're saying to you act, quit dragging your feet.

You say, Mr. Macklin, that it's complex, a lot of different aspects to it, a lot of different points. That's the reason that Congress so often takes the bit in its own teeth and does things. I'd be the first to stipulate we can't do it as well as you can do it yourselves, but if you don't do it, then we're going to do it. I totally reject this idea of giving the SEC the authority. That's manana, that's like appointing a committee to study something and meanwhile what's happening is that corporation after corporation in this country is changing their own charter, changing the bylaws and getting the horses out the door.

Now, all of us have been receptive to a grandfather clause, but not to grandfather people who are changing at this point. I guess I can say it to you in the most dulcet tones that I know and that is do it tomorrow or Friday, whatever the day is; get the show on the

road and kill the D'Amato-Metzenbaum bill. If you kill it, it will make this Senator very happy.

Senator D'AMATO. We'll even have a party with you. [Laughter.]

Senator METZENBAUM. I know you got a big campaign fund but I didn't know [laughter]—but I would say to you, act. We're giving you a message that's loud and clear, and I agree with the Senator from New York, the chairman, we don't need to worry about the whole committee process. There are bills out there every day of the week on which you can hang an amendment, and I think this amendment will fly on the floor because it just sounds as American as apple pie—one share, one vote. Do it on your own. But don't require us to do the job that you should be doing.

Senator D'AMATO. Well said.

Senator Riegle, we have one more panel.

Senator RIEGLE. Thank you very much.

Senator D'AMATO. Thank you all for coming in. Mr. Howell.

STATEMENT OF WAYNE HOWELL, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. HOWELL. Thank you, Senator D'Amato. My name is Wayne Howell. I'm director of the securities division for the secretary of the State of Georgia, and I am appearing here today as president of the North American Securities Administrators Association, which is the organization that represents the State securities administrators from all 50 States, the District of Columbia, Puerto Rico, and the Canadian Provinces.

I would like to have my testimony included in the record in its entirety, and I will try to very quickly go over a couple of points that I would like to bring to the attention of the committee.

Our concern is primarily investor or shareholder abuse and also State economic development. I agree with Senator Proxmire that our country has the best capital markets in the world, and part of that is the responsibility and is the result of the oversight of the Congress, the SEC, and the self-regulatory organizations, and, hopefully, the State security regulators.

I would also like to refer back to our previously submitted statements on corporate takeovers, the one on June 2, 1983, to the SEC Advisory Committee on Tender Offers, and also on March 28, 1984, to the House Subcommittee on Telecommunications, Consumer Protection, and Finance. Then, finally, on October 2, 1984, before the Senate Committee on Banking, Housing, and Urban Affairs.

NO INTRINSIC BENEFICIAL VALUE TO HOSTILE TAKEOVERS

I think what we're talking about here today is hostile takeovers and I think everyone agrees—or not everyone agrees, but I think the regulators agree, that there is no intrinsic beneficial value to hostile takeovers. You can only look at the abuses that have occurred, and I think that is evidence within itself.

Something really needs to be done and I think Congress is going to do it. If it doesn't do it, it needs to be mindful of the resolutions that have been made by the National Governor's Association, the National Association of Secretaries of State, and the National Asso-

ciation of Attorneys General urging the State role in the corporate takeover area.

We are also concerned with the Williams Act, which is one of the things that you're looking at, which is not neutral and not even-handed.

The corporate raiders have a clear advantage and we are concerned about that effect on the shareholder abuses that are occurring.

We would like to make just a couple of recommendations. They are in full in my testimony, but just to refer to them very, very quickly, we would like to see the minimum time period extended from 20 to 60 days. Even Mr. Pickens said when he was talking about the countertactics, that he had to have those because the time period was too short.

Our second recommendation would be the so-called Martin Lipton proposal concerning the root cause of several of the worst abusive practices such as creeping tender offers, greenmail repurchases, and two-tier tender offers.

It has been suggested that this occurs either after the 5 or 10 percent level. We are not taking a position on the percentage, but we feel that is very, very important.

Very, very quickly, Senator D'Amato, that is our concern. Our concern is with the investor and with the protection that we feel the investor and the shareholder needs.

Senator D'AMATO. Let me first express my gratitude for your patience, for your coming in, for your really synthesizing and crystallizing your points. We are deeply appreciative. We will conclude with your testimony.

This committee stands in recess. Thank you.

Mr. HOWELL. Thank you, Senator.

[Whereupon, at 12:10 p.m., the hearing adjourned.]

[The complete prepared statement of Wayne Howell follows:]

[Additional material supplied for the record follows:]

Statement of Wayne Howell,
President,
North American Securities Administrators Association

Mr. Chairman and Members of the Subcommittee:

My name is Wayne Howell. I am Director of the Georgia Division of Securities and President of the North American Securities Administrators Association (NASAA). NASAA is the association of the 65 state and provincial securities administrators from the United States, Canada and Mexico, charged with the responsibility for administering and enforcing securities laws. NASAA works to protect investors and to ensure that the securities markets operate with a minimum of abuse.

I appreciate the opportunity to appear before this Subcommittee concerning a problem which many rightfully perceive to be a very serious one; that is, the hostile takeover phenomenon. Indeed, as Justice Arthur Goldberg, public member of the Securities and Exchange Commission's Advisory Committee on Tender Offers (SEC Advisory Committee), stated during the course of its deliberations, the perception is that hostile tender offers are a national scandal or fiasco.

Securities administrators across the country are concerned not only with the shareholder investor abuses caused by the proliferation of hostile tender offers, but also, as state officials at the grassroots level, while not directly involved in state economic development, we are concerned with the actual or perceived impact of hostile takeovers on the economies of the states and local communities. It is thus both from the viewpoint

of investor protection and as state officials that the following comments are offered.

I will not go into any greater detail than necessary concerning NASAA's previously expressed position on hostile tender offers and amendments to the Williams Act. Instead, I refer you to our comments to the SEC's Advisory Committee on Tender Offers given on June 2, 1983; a statement by Michael Unger, then president of NASAA, before the House Subcommittee on Telecommunications, Consumer Protection and Finance on March 28, 1984; and my statement before the Senate Committee on Banking, Housing and Urban Affairs given on October 2, 1984.

In our statement today, we would like to emphasize several points concerning amendments to the Williams Act. First, hostile tender offers are not intrinsically beneficial. Second, the present Williams Act is neither neutral nor even-handed in its application, but rather gives tremendous timing advantages to a bidder due to the short 20 day minimum offer period. We would also like to comment briefly on past, present and future state-level legislation in the hostile tender offer area and to make some specific reccomendations on amendments to the Williams Act.

While insiders and Wall Street arbitragers may make some quick profits speculating on the prices of takeover targets, the "average shareholder" often ends up as just another victim. The reforms that NASAA proposes, from increased time limits to restoration of state authority, are designed to protect the interests of "average shareholders" by preserving his or her

opportunity to make informed and prudent investment decisions. Such reforms can only strengthen the efficiency of our capital markets.

We feel strongly that such amendments to the federal scheme should not be piece-meal in approach nor merely deal with specific abusive practices currently in vogue. Rather, amendments should be directed at the root causes that have led to the hostile tender offer abuses by both bidders and target companies, resulting in the scandalous state of affairs that presently exists. We say "scandalous state of affairs" because Subcommittee membes can read every week, nearly every day, about some new or ongoing hostile takeover battle involving one or another of the litany of abusive practices by the bidder, the target company, or both.

Let us first analyze whether or not hostile tender offers are intrinsically good. We recognize that sometimes tender offers may be economically useful and beneficial to shareholders and the nation. However, that is far from always the case. One has but to look at the long list of abusive takeover practices by both bidders and target companies to realize that something is terribly amiss. Can anything that has created such a plethora of negative activities and results, memoralized by descriptive and colorful code names, be good? We need only mention a few: (1) greenmail, where millions of dollars of debt is added to corporate balance sheets in order to buy off high-flying corporate raiders and speculators; (2) the unproductive use of capital

where billions of dollars of equity debt capital is being tied up in economically unproductive takeover bids, rather than for the building of new facilities or for use in research and development; (3) millions of dollars spent by corporations to keep on "standby alert" and in the actual engagement of lawyers and investment bankers to fend off other players in this game of corporate monopoly. Also, corporate management is often forced to divert its attention from operating a company to dealing with threatened or actual takeovers, as well as being forced to have corporate decision-making unduly affected by short-term considerations; (4) defensive tactics such as pac-man defenses, crown jewel sales, and scorched earth policies that result in corporations being gutted by their own hand for the purpose of rendering the company less attractive as a hostile takeover target; (5) two tier offers by bidders that coerce shareholders into tendering before competing bids can develop; (6) the concentration of economic power in precariously debt-laden companies; and (7) the golden parachutes where management of possible target companies provide a form of "takeover hazard insurance" for themselves with the provision for handsome economic benefits in the event of a takeover. The list of abuses has grown as new hostile bidder devices, as well as target company defenses to hostile bids, continuously evolve.

This scandalous state of affairs nationally is evidenced in the Mess Petroleum hostile bid for Phillips Petroleum, which saw a "greenmail" buy-out of bidders, and incident to it, a

restructuring of the debt and equity structure of the target company. The restructuring will involve the sale of a significant portion of Phillips assets and the incurring of substantial debt in order to buy out the bidder, thus doubling the target's debt-to-equity ratio to 70%. This is just one example of a combination of many abuses incident to one hostile bid. The chilling spectre beyond the immediate Phillips Petroleum situation is pointed out in a January 7, 1985 Newsweek article, describing the matter, which stated that the next targets of this takeover bidder device could be Sun Oil Co. or Mobil Oil. We ask each Subcommittee member to reflect as to whether this nation is well served by having every domestic oil company devasted by a sale of its assets and over-leveraging itself with a staggering debt load, rendering it vulnerable to collapse in any future economic downturn? The oil industry is just one segment of corporate america that is beset by hostile takeover excesses.

We now see more and more hostile takeovers in the communications and media industry. We are all aware of the controversial Turner Broadcasting Company bid for CBS involving a shopping list of financing, including junk bonds.

Unless there is some overwhelming reason for the encouragement of hostile takeovers, the fact that the hostile takeover phenomenon has created this litany of negatives should be reason alone to enact changes to the Williams Act to eliminate the abuses.

The argument most often used to justify either the en-

couragement of hostile tender offers or the adoption of at least a so-called "neutral" approach is the theory that the threat of a hostile takeover keeps incumbent management on its toes -- the so-called "entrenched management" syndrome which hostile takeovers are alleged to remedy. Corporate raiders in testimony before congressional committees and elsewhere proclaim that they are the defenders of the corporate shareholder and champions of corporate democracy against entrenched management. These arguments and protestations are sheer nonsense.

In the real world, takeover bids are made not because a target's management is entrenched or slothful, but because the acquisition of the target company is felt to be beneficial for the offeror. Bidders are not interested in acquiring a poorly run company, but rather seek those targets that are underpriced in the market. Takeover bids are not made by disgruntled shareholders seeking to oust a slothful management. For example, in the U.T.C. takeover bid for Carrier Corp. in 1978, U.T.C. Chairman Harry Grey testified at the public hearing that he had the highest regard for the management of Carrier Corp. and indeed proposed that Carrier representatives be added to the board of U.T.C. The fact is that our present securities market system often does not accurately reflect the higher value that a stock is worth in the hands of a hostile bidder. It is this premium price that state legislatures have used as the basis for their "control share acquistion" statutes which provide for a vote by the shareholders of corporations to accept or reject an offer.

Corporate America, its management in particular, has been put in a form of anxiety neurosis as a result of the hostile takeover phenomenon with a constant "fear and flight" state of mind.

As pointed out by an eminent former member of the SEC, Frank Wheat, at a Practicing Law Institute forum on November 1, 1984, corporate managers are formulating plans and decisions for their companies not on the basis of the long term benefits for the company, but on how these plans and decisions will affect the short term. For if the short term does not result in a favorable market price for the security of the company, the possibilty of a hostile takeover increases dramatically. Is this a desirable environment for our industrial and business complex?

We maintain that it is not. For instance, should our defense and military industrial capabilities be subject to the possibility that defense concerns are overly concerned with the short term? Corporate America should not be subject to this neurosis and should be treated accordingly. I respectfully refer this Subcommittee again to the excellent presentation of Commissioner Wheat in its entirity, but specifically call your attention to his quote of Felix Royatyn, whose knowledge and prominence in investment banking generally and tender offers particularly needs no additional description. Commissioner Wheat quotes Rohatyn's warning that:

> The tactics used in corporate takeovers, both on offense and on defense, create massive transactions that greatly benefit lawyers, investment bankers and arbitraguers,

> but often result in weaker companies and do not treat all shareholders equally and fairly... I believe we are reaching a point where the integrity of our financial market is in question and, after all, that has been the basis of the success of our free enterprise system.

The response by state legislatures to the hostile takeover phenonemon is also worth noting in considering the intrinsic benefit of hostile takeovers. The legislatures of thirty-seven states enacted legislation in the takeover field in response to the fear of losing local industry during the aftermath of a hostile takeover bid. The states' local economies were threatened and they responded. The prospect of plant closings and the removal of jobs with its ripple effect upon suppliers, subcontractors, and the local communities in general, including its charities, schools, small businesses, and tax base consequences is so frightening that state legislatures responded.

In addition to the concerns of the state legislatures, other state officials have recognized the harm that can befall a state or local community when a local industry is forcefully taken away. It is worrisome enough when an industry is forced out of a community because of routine economic pressures, but additional pressures caused by the possibility of an unwanted hostile acquisition becomes a source of overwhelming concern. So it is that after the Supreme Court's decision in Mite, the National Governors' Association, the National Association of Attorneys General and the National Association of Secretaries of State passed resolutions calling for a state presence in the hostile takeover field in an effort by these state officials to

inform Congress that there is a need for a significant state role in the regulation of takeovers.

State securities administrators, as hearing officers under our respective state statutes, have personally witnessed the threat of a hostile bid. Thus we have heard the concerns of representatives of labor, of pensioners, of local suppliers and subcontractors, of local governmental officials and the local academic and charitable institutions that depend on the local presence of a target company. We have seen the threats become reality. For example, Otis Elevator was located in Yonkers, New York for a century. Otis was acquired by United Technologies Corp. of Hartford, Connecticut in 1975 by a hostile bid. While the raider had promised that the large industrial facility and white collar support staff, employing a significant amount of the Yonkers work force, would not be moved, a year or so ago Otis' plant was closed, resulting in great anguish for that city and its residents.

Corporate executives themselves who must survive in this jungle-like environment and who have hands-on experience with hostile tender offers believe that hostile takeovers are bad for the economy, according to a poll commissioned by BusinessWeek and reported in its August 27, 1984 issue.

With regard to the notion that the Williams Act in its current form is even-handed or neutral, unfortunately, the real world demonstrates there is no even-handedness, no neutral position. The corporate raider clearly has the advantage under

the Williams Act. Just as, if we may analogize to football, a split-end going out for a pass against one-on-one coverage has the advantage over a defending safety, so too does the raider over the target. It is obvious that the one who has the knowledge of where and when they are going has the advantage against the one who must react and defend against such moves.

In view of what has been happening in the real world of takeovers, we cannot understand on what basis the SEC has maintained its position that the Williams Act is even-handed and that the Act should not be changed with respect to the minimum offering periods or in other basic respects. It is especially hard to understand when the SEC's own study of two-tier offers demonstrated that such offers almost always guarantee success. The study reported that 87% of offerees tender in such offers. What has the SEC's past and purposeful unwillingness to slow down the pace of hostile takeovers led to? Its current "insider trading" enforcement priority is one result. More and more we read about a printer, lawyer, law clerk, or a corporate official or his friends or family being prosecuted for acquiring insider information relating to a hostile takeover. Would not the public be better served by a different enforcement priority? We were most gratified and encouraged to read of the January 9, 1985 speech by SEC Commissioner Charles Maranaccio in which he commented that the balance of power in takeovers has shifted radically for the bidder and against the target company. Commissioner Marianccio also outlined several specific proposals

to remedy abuses in the hostile t: over area, including elimination of coercive two-tier offers by requiring hostile offers to be for all of a target's shares and for indentical consideration.

We maintain therefore that hostile takeovers, which have resulted in so many problems and abuses, and which have the potential for a negative effect both on local and the national economy and on the future of a worldwide competitive and competent corporate America, are not beneficial and should not be supported or encouraged and that a truly neutral even-handedness be achieved. Any contention that the federal scheme is neutral or even-handed is a fantasy, belied by what the real world's events have shown to be true.

We urge that Congress recognize these realities and make the following two changes to the federal takeover regulatory scheme. The two recommendations are intended to address the root causes of tender offer abuses rather than merely trying to treat symptoms. The symtom-treatment approach is evidenced by the SEC's proposed legislation during the 1984 Congressional session prohibiting, among other things, "golden parachutes", "greenmail" repurchases and certain "lock-up" agreements. Even prohibiting two-tier offers, perhaps the worst of the abusive practices now prevalent, represents an "addressing the symptom and not the cause" approach. While there is nothing wrong with taking regulatory action to eliminate specific abusive practices, it is our view that a regulatory response (whether at the federal or the state level) that merely enacts prohibitions against current

abuses in vogue at the time is destined to be ineffectual in the long run because inventive minds (on both the bidder side as well as the target company side) can come up with new and potentially abusive techniques to be utilized in the future.

Our first recommendation is to extend the minimum tender offer period under the Williams Act from 20 to 60 days.

This recommendation deals with the root cause of abusive practices by both bidders and target companies. The 20 day period is far too short, thereby encouraging harmful practices by both bidders and targets. On the target/defense tactic side, it encourages the laundry list of abusive techniques to "buy time", such as lock ups, pac-man defenses and the sale of crown jewels. On the bidder side, the abusive practice of the two-tier offer has been developed to consolidate the bidder's timing advantage under the 20 day federal provision. Use of the two-tier bidding technique enables a bidder to acquire 51% of the target's shares (in the "first tier" of the offer) during the 20-day minimum period before the target company or its shareholders know what hit them and before competing offers can develop.

Providing for a longer minimum offering period will encourage competing bids. Experience has shown that once an entity is the subject of a hostile offer, it seldom survives as an independent company (falling prey to the original bid or to competing hostile bids, or entering into "white knight" mergers). Given that an entity, once so targeted, will no longer remain independent, the only issue becomes the price that will be received by

the target's shareholders. Empirical studies have shown that the longer the tender offer period remains open, the more an "auction" market of competing bids develops, resulting in continually higher prices being offered to target company shareholders. Presumably, not even the "Chicago School" of economists (who object to any regulation in the "Saturday night special" offers) can object to a higher price going to shareholders. However, what the Chicago School, as well as the U.S. Department of Justice's Anti-Trust Division, has objected to regarding this point is that a longer minimum offering period would inhibit bidders from initiating the first bid for control of a company because the possibilty for success of the bid is reduced since competing bids may develop.

The proper response to that objection is that nowhere is it provided that a first bidder automatically is entitled to "win" and obtain control of a target company "on the cheap" before competing offers at higher prices can develop. In the context of a merger, for example, nothing in state or federal law provides or implies that the first corporate suitor to propose merger terms to a target company is entitled to have the first merger offer be successful. Furthermore, the fact that there is no such provision in law or in the business world has stopped corporate suitors from proposing mergers.

I would again like to quote from one whose knowledge and overall proficiency in the field is well known and needs no further description -- that is from a letter of Martin Lipton,

addressed to Senator Alfonse D'Amato and Representative Timothy Wirth urging an extension of the offering period to 60 days.

> Extension of the tender offer period will give shareholders and boards of directors needed time to evaluate fully the merits of unsolicited tender offers without being subjected to the kind of intense pressure that now often leaves a board with no choice but to act hastily and, in some cases, rashly.
>
> Because the time pressure on boards of directors will be lessened, many actions that are justifiable in the pressured context of a 20-day offer period may be found to be inappropriate in the new context of a 60-day period. This will permit the state courts to give new content to the business judgment rule as applied to takeover decisions.

Our second recommendation, which also would address a root cause of several of the worst of the abusive practices by bidders (namely, the practices of creeping tender offers, greenmail repurchases and two-tier offers) is to adopt the basic elements of the so-called "Lipton" proposal. That proposal, as this Subcommittee is aware, was introduced in bill form in the 1984 congressional session and was considered by the House Telecommunications Subcommittee. The proposal requires that <u>if an acquiror wants to acquire more than 10% of the shares of a target company, the bidder will have to make an offer for all the shares of the target company</u>. Recently, it was announced that a similar proposal at a 5% level was submitted by Mr. Lipton to Senator D'Amato and Representative Wirth for consideration in this congressional session.

The root cause of many of the abusive bidder practices is that the current federal regulatory scheme <u>allows acquirors to</u>

achieve practical or actual control of a target while acquiring only some of the target's shares, either by stealth in creeping tender offers or by coercive two-tier offers. This leaves the remainder of the shares and shareholders out in the cold, either with nothing received for their shares or a reduced price squeeze out second step.

The Lipton proposal, whether at a 5% or a 10% level, treats the root cause of those abusive practices by requiring that any person seeking to acquire control must give each share of the target company the opportunity to participate equally in the acquisition of control and to receive equal payment for their shares. The underlying premise of the proposal is that control is an asset of the corporation. Since each share represents an equal proportional and undivided percentage of that control, each share is entitled to participate equally when control is sought or obtained by a bidder.

Because equal treatment for all shares is required under the Lipton proposal, acquisition by stealth in creeping tender offers is eliminated. Two-tier offers are eliminated because the "two-step" approach becomes moot since only "one-step" acquisition of control is permitted. Also, greenmail repurchases become less likely because bidders cannot acquire threatening levels of stock ownership.

We would emphasize at this point that enactment by Congress of these two recommendations will not prohibit hostile takeovers. Rather, their enactment will remedy the two root causes of

abusive bidder as well as defensive tactics that have made this area a national scandal. Enactment of the two recommendations will provide that once an entity is targeted for a hostile takeover, two elements would be in place: first, adequate time is accorded in the takeover process to allow the marketplace to act so that the "best" offer is successful -- not merely the first offer. Second, each and every offer that is made allows shareholders of the target equal treatment for all shares.

We conclude with some brief observations on state legislation in the tender offer field. There is now a so-called "second generation" of state takeover statutes; a generation subsequent to the Supreme Court's Mite decision. Recently, several states, including Ohio, Wisconsin and Minnesota, have enacted amendments to their state statutes in two areas: (1) amendments to their takeover laws to remedy the constitutional problems cited in the iteE decision; and (2) amendments to their business corporation laws to provide some measure of corporate democracy in a hostile takeover situation -- namely, a requirement that the shareholders of the corporation have to vote to approve whether or not a bidder should be allowed to take up and purchase shares tendered in the offer. Minnesota's second generation takeover statute also provides for administrative review by the securities administrator who must act within a twenty day period, and requires an economic impact statement as part of the tender offer disclosures.

We believe that other states will be encouraged to pass

second generation legislation because, within the last six months, the control share acquisition laws in both Minnesota and Ohio, as well as Minnesota's revised takeover law, have been upheld in the face of constitutional challenge on both supremacy clause and commerce clause grounds. Recently, comprehensive legislation on a state level has been introduced in other states, including the New York legislature.

If Congress acts in the manner we have suggested, it would remove a considerable level of the state's anxieties over the disruption of their local economies that occur from hostile takeovers. Consequently, there would be less urgency for additional states to pass similar legislation under their corporation laws or their takeover laws which could lead to another round of litigation, ending up in the Supreme Court, with its attendent confusion, uncertainty and delay. Even as we speak, state laws are being considered which will ensure that the state interest and role in corporate takeovers be maintained.

MERGERS AND ACQUISITIONS

PREFACE

Every profession develops specialized vocabularies; these serve to rid its internal discourse of cumbersome usages and to render complex ideas and practices in simple, concise terms, which, simplicity notwithstanding, may be perfectly opaque to the laymen. The field of corporate mergers and acquisitions describes its own participants and transactions with a set of terms which, if not lurid, is extremely colorful. A striking number of these terms derive from predation, crime, and warfare; some observers have cited this lexical violence as evidence of a need for reform. This glossary presents short definitions of a selection of terms associated with mergers and acquisitions which have appeared in the extensive literature on the subject.

A GLOSSARY OF TERMS

A

ARBITRAGEUR.—a professional stock trader who deals in the stock of companies involved in takeover contests, or companies which seem likely to become involved in such contests in the near future.

B

BEAR HUG.—notification of a target company's management that a tender offer is imminent or under consideration. There are several variations: the "strong bear hug," in which the tender offer is made public, intensifying the pressure on the target company; the "teddy bear hug," an offer management believes it can fend off; and the "reverse bear hug," when the target company replies that it favors the merger, but at a much higher price than the one offered.

BIDDER.—the person, group or company making a tender offer for control of another company.

BLACK BOOK.—an outline of defensive tactics to be employed should a hostile takeover attempt be made.

BLOCK PURCHASE.—the acquisition of a large number of a company's shares. The purchaser can exert pressure on the company even without making a formal takeover bid—"greenmail" (see below) is a possible result.

BOOT STRAP.—See "Two-Tier Tender Offer."

BUSINESS JUDGMENT RULE.—a legal concept embodied in various State corporation laws which has provided management and boards of directors with virtual immunity from shareholder suits because their decisions can be challenged only on very limited grounds. Directors and managements of target companies often invoke the rule in defending themselves against shareholder suits which accuse them of acting in their own self-interest during takeover bids. Recent court decisions have lessened the immunity provided by the rule.

C

CREEPING TAKEOVER.—the gradual accumulation of a company's stock through purchases in the open market. Since Federal law requires no public disclosure of stock ownership or takeover intentions until one's holdings total 5 percent of a company's shares (see "section 13(d)"), a bidder may control a substantial portion of the target company's stock at the outset of a takeover contest.

CROWN JEWELS.—a firm's most valuable assets. To defend against a hostile takeover, the "crown jewels" may be sold or optioned to a third party, thereby making the company less attractive to the bidder.

D

DEFENSIVE TACTICS.—actions taken by a target company to resist a takeover.

DROP DEAD FEE.—a fee paid by bidders to lenders when a proposed acquisition fails and the lines of credit established to finance the acquisition are not used. This arrangement allows bidders to commit themselves to large acquisitions, often worth billions of dollars, without actually having to borrow the money and risk overextending themselves in the financial markets.

E

F

FAIR PRICE PROVISIONS.—corporate charter or bylaw provisions requiring a bidder to pay the same price for all shares purchased. The intention is to prevent two-tier takeover bids (which see), in which one price is offered for some of the target's stock, and a lower price for the remainder.

FREEZE-OUT.—a type of merger in which a group or company which has obtained a controlling interest in another company forces the remaining shareholders to give up their interest in that company.

FRIENDLY TAKEOVER.—a merger supported by the management and board of directors of the target company.

FRONT-END LOADED TENDER OFFER.—see "Two-Tier Tender Offer."

G

GODFATHER OFFER.—a tender offer so generous that the target company management cannot reasonably refuse.

GOLDEN PARACHUTES.—employment contract provisions that guarantee very substantial severance payments to top management if they lose their jobs as the result of a takeover.

GREENMAIL.—a payment received (some would say extorted) from a company by a "raider" who has purchased a block of the company's stock and threatens to make a hostile tender offer. In order to negate the threat, the company buys the block of stock from the raider at a premium, that is, it pays more than the going market price. As a result, the value of other outstanding shares often decreases, thereby injuring the other shareholders.

GREY KNIGHT.—a company which enters into a takeover contest between two (or more) other companies, and whose intentions are ambiguous and not entirely welcome to either party. In contrast, a "white knight" (see below) comes to the "rescue" of the target firm.

H

HOSTILE TAKEOVER.—a merger resisted by the acquired firm.

I

INVESTMENT BANKER.—a financial intermediary, one of whose functions is to advise firms involved in or contemplating mergers and acquisitions. An investment banker's services may include selecting target firms, formulating strategy and tactics, and arranging financing.

J

JONESTOWN DEFENSE.—defensive tactics so extreme as to appear suicidal. The term first appeared during the Bendix/Martin Marietta/Allied/United Technologies merger battle.

JUNK BONDS.—high yield bonds are all issues rated below "investment grade"—those which are rated Ba1 or lower by Moory's, BB+ by Standard & Poor's, or unrated. They have been drubbed pejoratively "Junk Bonds", a term originally used by the investment community to describe downgraded debt securities of companies which had suffered business downturns.

K

L

LADY MACBETH STRATEGY.—a strategy wherein a third party appears to come to the aid of a target company in a hostile takeover attempt, in the manner of a "white knight" (see below), but then changes allegiance and joins with the acquiring firm.

LEVERAGED BUYOUT.—a transaction in which a group of investors acquires and "takes private" a publicly-owned company (or a division or subsidiary of a firm). The acquisition is usually initiated by an investment banker, often in partnership with members of the firm's management. The transaction also depends on borrowing most of the purchase price, using the firm's assets as collateral. Leveraged buyouts have been undertaken to prevent hostile takeovers.

LOCKUP.—an agreement between a target company and a proposed acquiror giving that acquiror an advantage over other potential bidders. Lockups may include: a stock purchase agreement for treasury or unissued shares, an option to buy treasury or unissued shares, an option to buy certain assets, a merger agreement, and other provisions.

M

MINIMUM OFFERING PERIOD.—the shortest time a tender offer may remain open—20 business days under current Federal law.

MITE CASE.—the Supreme Court decision of *Edgar* v. *MITE*, 102 S. Ct. 2629 (1982), which struck down the Illinois tender offer law as an unconstitutional restriction on interstate commerce.

N

O

P

PAC-MAN DEFENSE.—a tender offer made by the target of a hostile takeover bid for the stock of the original bidder.

POISON PILL.—an issue of securities, usually preferred stock, designed to discourage a hostile merger bid. Upon completion of a hostile takeover, the typical "poison pill" stock becomes convertible into cash or into the common stock of the acquiring company. The effect is to raise considerably the cost of the acquisition.

PORCUPINE PROVISIONS.—corporate charter or bylaw provisions meant to deter takeover attempts. For examples, see "fair price provisions," "golden parachutes," "poison pill," and "supermajority provisions."

Q

R

RAIDER.—a person, group, or company attempting to execute a hostile takeover. The term is frequently applied to those who specialize in hostile takeovers.

S

SANDBAG.—a delaying tactic, in which a target company agrees to negotiate a takeover bid, but seeks to draw out the negotiations as long as possible, hoping that it will be saved by a "white knight" or otherwise achieve a more favorable outcome.

SATURDAY NIGHT SPECIAL.—a tender offer made without the prior knowledge of the target company, and open for only the minimum offering period. The term dates from the 1960's when the minimum period was only 5 business days (versus 20 under current law), and when announcing tender offers during the weekend was a common practice.

SCORCHED EARTH DEFENSE.—the use of extreme defensive tactics which threaten to leave the target firm a financial cripple. Two examples: scheduling all debt to come due immediately upon the completion of a takeover; selling the "crown jewels" (see above). In one celebrated case, a group of Houghton Mifflin's authors threatened to find other publishers were that firm taken over.

SECTION 13(d).—the section of the Securities Exchange Act of 1934, as amended by the Williams Act of 1968, which requires that notice be filed with the Securities and Exchange Commission [SEC], with the target company, and with each exchange on which the target's securities are traded, within 10 business days after any person or group acquires "beneficial ownership of 5 percent or more of a class of registered equity securities." The disclosure form (SEC schedule 13D) must include, among other things, the source of funds for the acquired securities, the purpose of the acquisition, and the buyer's future plans with respect to control of the target.

SECTION 13(d) WINDOW.—the 10 days between the acquisition of 5 percent or more of a firm's stock and the required public disclosure (see "Section 13(d)" above). During this period the acquiror may continue to buy the target firm's stock, and thus may own considerably more than 5 percent when the disclosure is made. (See also "Creeping Takeover," above.)

SELF-TENDER.—a company's purchase of its own shares. This is frequently done to remove the shares from the reach of a hostile bidder, thereby lessening the prospect of the bidder's obtaining a majority of shares.

SHARK REPELLENT.—provisions in corporate by-laws designed to prevent hostile takeover bids (see also "Porcupine Provisions"). Also used for defensive tactics in general.

SHARK WATCHERS.—consultants who help corporations identify buyers of their stock, in order to provide early warning of takeover attempts.

SHOW STOPPER.—a lawsuit by the target company seeking a permanent injunction against the takeover bid.

SILVER WHEELCHAIRS.—see "Golden Parachutes."

STAGGERED DIRECTORSHIPS.—a defensive tactic—by staggering corporate directors' terms (having terms begin in different years, so that all directors are

not elected at once), an acquiring company can be prevented from electing its own directors quickly.

STANDSTILL AGREEMENT.—an agreement whereby the bidder agrees to buy no more of the target's stock for a specified period of time.

SUPERMAJORITY PROVISIONS.—corporate bylaw provisions requiring that certain decisions, such as approval of a merger, pass by vote of a "supermajority" (70 to 80 percent) of shareholders.

T

TARGET.—the company that is the subject of a takeover bid.

TENDER OFFER.—a public offer to buy some or all of the stock of a corporation within a specified time period. Notice of the offer must be filed with the Securities and Exchange Commission on schedule 14D-1, disclosing, among other things, certain financial information about the bidder. The price offered is generally well above the current market price of the stock, to induce stockholders to tender their shares to the bidder.

TWO-TIER TENDER OFFER.—an offer to pay a certain amount per share, usually in cash, for a controlling interest in a corporation's stock, and then to acquire the remainder of the stock at a lower price, usually by means of an exchange of stock or a combination of cash and stock. Bidders using this technique hope that shareholders will "stampede" to tender their shares for the higher price offered on the "front end" of the deal, regardless of the wishes of the target company's management. This type of offer is also known as a "front-end-loaded tender offer."

U

V

W

WARRANT HOLDERS.—warrants distributed by the target board of directors as dividends to shareholders. In the event of a hostile takeover the holders may have the right to purchase bidders shares of stock at a deep discount.

WHITE KNIGHT.—a third party who agrees to acquire a target company, usually at that company's request, as an alternative to a hostile takeover by another bidder. The merger proposed by the "white knight" generally offers terms more favorable to the target company's management, and a higher price per share to stockholders.

X

Y

Z

International Business Machines Corporation

Office of the Assistant Treasurer
Corporate Headquarters

1200 High Ridge Road, P.O. Box 10[illegible] Stamford, CT 06904

April 29, 1985

The Honorable John H. Chafee
Chairman, Subcommittee on Taxation
and Debt Management of the Senate
Finance Committee
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

I would like this letter to become part of the official record of the subcommittee hearings on April 22, 1985 concerning hostile merger activity.

Two witnesses appearing before your committee on April 22, 1985 stated that a number of corporations, including specifically IBM and the IBM pension fund had purchased so called "junk bonds."

IBM denies that we have ever participated in the buying of "junk bonds." We have no money managers who are chartered to purchase "junk bonds" for us or our retirement plans. In addition, none of our funds contain any significant amount of "junk bonds."

IBM wishes to make this part of the record to clearly establish that IBM's portfolio holdings and IBM should not to be used to either credit or discredit positions on hostile take-overs or mergers.

Sincerely,

Bruce E. Langton
Assistant Treasurer

BEL/smk

85-24

STATEMENT BY THE
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS,
ON CORPORATE TAKEOVERS
BEFORE THE SUBCOMMITEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

For The Hearing on June 12, 1985

The AFL-CIO appreciates this opportunity to address the Subcommittee on the issue of corporate takeovers.

Workers and their unions have a logical and vital interest in the corporate takeover issue. Corporate mergers and takeovers often have serious effects on jobs, wages, working conditions, and job security of working people.

Workers and their families and the communities in which they live are seldom, if ever, represented in the proceedings which surround corporate merger and takeover proceedings.

Labor unions have a clear, direct, and obvious interest in protecting the interests of workers and their families, as well as a strong interest in the economic and social health of the nation.

Corporate raiders and corporate defenders in the takeover wars hire and pay huge amounts of money to high-priced financial and legal consultants. But neither the attackers nor the raiders in hostile corporate takeover battles --nor the willing would-be partners in a friendly corporate merger -- give consideration to the jobs and the welfare of their workers and the workers' families and the communities in which these people live.

It is obvious to us, therefore, that mechanisms must be developed which protect the interests of workers and communities in corporate merger and takeover proceedings.

The merger-takeover mania of big business and big banks adversely affects the availability of credit for productive investment. The billion of dollars used to finance, as well as to fend off takeovers is money that is not available for strengthening the national economy. The time, effort, and imagination that corporate managers devote to waging and combatting takeover battles are time, effort, and imagination that are being siphoned off from the more important tasks of building better products and providing better services at a better price. America can ill afford this waste of scarce resources; and the losses being suffered now are only the beginning.

One unfortunate result of the current merger-takeover epidemic is that business firms that want to avoid takeover will maximize short-term profits at the expense of capital investment, research and development in order to keep the price of their stock at relatively high levels. In the long run, this way of doing business is the certain prescription for economic ruin. To be progressive and competitive in the long run, business firms must keep up their R&D and investment for future growth.

No matter which side wins control in a takeover battle, workers, customers, and the community in which the company is located are the likely ultimate losers. The company normally winds up saddled with added debt or otherwise weakened. Workers too often involuntarily finance the costs of the raid by job losses or pay cuts. And consumers end up paying higher prices for the company's products. If the costs cannot be passed off to others, productive assets are liquidated -- again to the detriment of workers and their communities. Indeed such "bust-up" financing is common in hostile takeovers.

The merger-takeover mania increases the concentration of economic power -- and this power too often is used against the interests of workers, consumers, and

the general public. When corporate mergers and takeover efforts succeed, corporate concentration is increased. Such concentration in the communications media threaten freedom of the press. In the oil industry, reduced competition has further weakened the power of consumers to deal with the concentrated power of a few conglomerates. The power of big corporations and big financial institutions is getting bigger and bigger as a result of mergers and takeovers.

Corporate power and corporate misconduct must be brought under control. A wide range of reform is necessary, including:

* Effective enforcement of anti-trust laws
* Prohibiting huge conglomerate mergers
* Prohibiting interlocking directorates
* Setting triple damage compensation for all victims of corporate price-fixing, including secondary customers
* Stronger penalties for consumer fraud and price-fixing by corporate officials
* Protecting privacy rights against lie detectors and other invasions of privacy
* Checking communications media concentration and establishing more controls on oil company intestments in competing energy sources and in other non-oil investments.

Business Week (June 3, 1985) recently carried a report on the question "Do Mergers Really Work?" The answer was "Not very often -- which raises questions about merger mania."

In fact, the report declared, "In an era of ever-increasing and ever-bigger mergers, a remarkable number -- somewhere between a half and two-thirds -- simply don't work."

Business Week notes that the merger-takeover games "are aided by a benevolent tax code and abetted by an indifferent antitrust apparatus." And the magazine asks "If more than half of these deals flop in good times, what happens in the next recession? The costs can be heavy for managers and stockholders."

You will notice that Business Week is not worrying about the workers who are affected and their families and their communities which may suffer from the poor judgment of the top executives juggling their junk bonds and funny-money takeover financing deals.

The epidemic number of corporate takeovers in 1984 and 1985 is the latest of several waves of business mergers that have occurred periodically in the United States during the past 100 years. A few facts and some examples from the record of the sixties and seventies will highlight some of the consequences flowing from the periodic merger manias.

One set of statistics published annually by the W.T. Grimm Company shows that 40 out of 100 acquisition transactions during the 1970s led to sell-off transactions. A study of acquired firms with assets over $100 million found that more than one-third of the lines of business engaged in by the acquired entities in 1950 were no longer maintained by the acquiring corporations in 1975.

Another study found that acquired units were most often sold off because there had been performance failure "often aggravated by inept parent management and/or treatment by the parent of the subsidiary as a cash cow to be milked and then discarded."

A specific case in which the latter practice apparently was followed was the acquisition of Youngstown Sheet and Tube (YST), the eighth largest iron and steel company in the country, in 1969 by the Lykes Corporation, a holding company engaged primarily in the steamship business. YST had 26,000 employees and over

$1 billion in assets. Lykes had only $376 million in assets. It borrowed a great deal of money needed to acquire YST. It issued $191 million in debentures and borrowed $175 million from banks.

YST was an attractive takeover because it had an annual cash flow of about $100 million. The president of Lykes said at the time of the takeover, "I will not hesitate to use Youngstown's $100 million annual cash flow to move into other fields if our views on the future of steel should change." Youngstown's debt-to-equity ratio rose from 35 percent before the takeover to 75 percent after the merger. A good deal of YST's cash flow was used by Lykes to pay interest and other carrying charges for loans it acquired to finance the merger. It also used cash flow to help subsidize the steamship operation. Meanwhile, at the large Campbell Works steel plant in Youngstown, equipment was neglected and modernization, including installation of new furnaces, was not carried through. In 1977, the Campbell Works was closed, laying off 4,200 workers and making a significant adverse effect upon the economy of Youngstown.

Another case in point was the acquisition in 1967 by North American Rockwell (now Rockwell International) of Draper Looms. Rockwell immediately reduced the Draper Looms R&D staff; they reduced and subsequently eliminated the company's maintenance staff. In the first two years, Draper Looms' corporate savings amounting to between $30 and $40 million was transferred to the parent company. Draper assets, that were not directly involved in the manufacture of looms, were sold off or given away. The machinery that was vital to Draper operations, but was also useful in other subsidiaries of the parent, was transferred. Over a period of years, Rockwell closed the manufacturing facility in Hopedale, Massachusetts, slowly selling assets and laying off workers. The 2,400 people employed in the town of 4,000 residents lost their main source of income, property values declined, and the town faced bankruptcy.

The Lykes-Youngstown takeover and the Rockwell-Draper Looms acquisition are well-publicized cases where thousands of workers lose jobs. These are the big cases that attract public attention.

Let me call your attention to a few of the many smaller and less well-known cases where takeovers also led to lost jobs.

In 1983 the Chattanooga Glass company used a leveraged buyout to cut itself off from its parent company, the Dorsey Corporation. Chattanooga Glass then bought the Glass Container Corporation and closed down two of its facilities, one at Gas City, Indiana, with 167 workers losing their jobs and another at Jackson, Mississippi, where 219 workers lost their jobs.

Then in 1985, Chattanooga Glass, now with the new name of Container General, was bought by Diamond Bathurst which shut down a plant in Palestin, Texas, and threw 349 workers out of their jobs.

Another similar unpublicized sellout and shutdown in the glass industry occurred in 1983 when the Westrey Corporation bought Midland Glass company and immediately shut down the Midland plant in Terre Haute, Indiana, throwing 472 workers out of their jobs.

Many of the same and additional adverse consequences for communities and workers resulted from the takeover mergers of the eighties as occurred in the seventies. However, the magnitude in terms of dollars involved, the variety of techniques for takeovers, and a number of tax factors that come into play are new. In 1984, according to one account, the total amounts involved in mergers added up to $122 billion. Securities firms have established special divisions for takeover operations. They are manned by talented, highly paid experts in finance, law, and taxation, and lobbyists who can enlist political backing. They map out the strategic campaigns, arrange for the necessary credit, and earn very high fees, running into tens of millions of dollars in some cases.

A whole new class of "raiders" has developed who make a practice of mounting acquisition campaigns against firms that have large cash accumulations or valuable tangible assets, or large cash flows. The proposed acquisitions often require much greater amounts of capital than the raiders possess. The basic technique, which may take different forms, is still to borrow the funds and then repay the incumbent debt by selling off assets of the company to be acquired or using its accumulated cash, or obtaining funds from the annual cash flow.

One form of borrowing that has become popular is through the issuance of "junk bonds." These are bonds with little tangible security when issued, posing a high risk for bond purchasers and bearing high interest rates. An illustrative, recent proposal of this sort was that by Ted Turner who wanted to issue such junk bonds, and as publicly announced, to acquire CBS with the bond proceeds and pay off the bonds by selling some of the CBS assets.

Another form of "painless" borrowing is for the acquiring company to issue stock in exchange for stock held by shareholders of the company being acquired. The latter avoid taxes on any capital gains they may be realizing in the exchange.

Then, of course, there is the avenue of borrowing large amounts from banks, who receive a commitment fee beforehand, may charge above-prime interest rates, and require repayment over a relatively short period.

There is very little, if any, economic gain for the country through such merger acquisitions. The aggressor company desiring to execute the takeover may look forward to certain tax advantages which would come with the acquisition. For example, the takeover target company's assets may have already been depreciated, especially under the accelerated cost recovery system. They would be revalued, however, at a figure commensurate with the probably inflated takeover cost (arising from bidding up the price of the stock shares in the course of the

takeover). This would provide the aggressor takeover company with a large amount of tax write-off against income from other operations. The target company might also possess net operating loss credits from operations of recent years which it can carry forward into the next few years. The successful aggressor can acquire such tax credits for future use with the takeover.

In addition, there may be the typical sell-off of assets which do not fit into the types of business operations being run by the acquiring corporation. In some cases, the sale of assets may be in contemplation of closing down the business operation of the acquired company. This was contemplated, for example, by the aggressor who sought to take over the Pabst Brewing Company a few years ago. One of his proposed operational alternatives was to sell off breweries which were located on valuable urban real estate. Similar considerations have been involved in contemplations of takeovers of supermarket grocery chain store companies. Many of the stores and their adjacent parking lots are sitting on valuable land. What would follow such a takeover would be the shutdown of many stores to build high-rise properties that would yield a higher return. Short-run profits could be realized simply by selling the land.

Even where a new corporate owner does not sell or close down the tangible assets of the firm taken over, it may cause significant injury to the local tax base and the employees' pay scale. The encumbrance of large amounts of additional debt, to consummate the acquisition and then to make the required debt service payments, places the acquiring firm in financial straits, as additional interest has to be paid on junk bonds and/or bank loans, as well as the repayment of principal of such loans. The business operation that had been acquired is saddled with higher costs. It cannot be as competitive selling its products as before, and it will put greater pressure on its employees to hold down wages, possibly pressing for concessions and being unwilling to provide wage increases.

In cases where the target company manages to fight off an agressor, it may also, as a result, be saddled with a much higher debt. This may occur where a raider agrees to back away from the takeover by collecting "greenmail." The raider, who would have acquired a significant percentage of the shares of the intended victim company and has raised the market price of shares in the process, may agree to sell the shares to the company intended to be taken over at the inflated stock price. As a result, the raider walks away with a huge profit, while the company which has warded him off has either had its cash reserves depleted, or has encumbered a good deal of debt in order to raise the cash to buy the shares from the raider at a high price.

Some companies that paid sizeable amounts of greenmail in recent years included Castle & Cooke $71 million; Warner Communications, $180 million; Quaker Oats, $47 million; and Texaco, $1.28 billion. Another recent case was that of Phillips Petroleum which managed to protect itself by paying greenmail, but in the process assumed a much greater outstanding debt than it had previusly. Such a firm is then in a weakened position and is much more vulnerable to the next raider that may come along.

The takeovers do not enhance the efficiency and productivity of the economy -- notwithstanding claims by those who have a theological belief in the beneficial properties of a totally unregulated free market. There are rarely, if ever, any new jobs created by the takeovers. The incentive for raiders and others who seek to gain control of a company is generally to profit by gaining control over existing assets of the company being taken over. It is not to the advantage of the community or the national economy to have such takeovers consummated. In fact, the history points to the cessation of many business operations as operating businesses are dismantled. The brunt of the damage that is done is borne by the

employees who become unemployed and by the local community which has its tax base reduced.

The national economy also suffers from the dislocations which result, and the national Treasury suffers as tax benefits are transferred from companies who might not be able to use them to offset tax payments due, to those that can use them to reduce their tax payments.

The results of such takeovers are not the blessings of free market allocation of resources bestowed upon the community. They are the gains which accrue to greedy accumulators who may at times be paid off to go away -- in this instance -- or may gain control and milk the ongoing enterprise to the detriment of the workers and the local community.

The President of Control Data, William C. Norris, has pointed out the following negative implications of corporate takeovers:

> o Misuse of Scarce Capital. First, many takeovers have been accomplished through massive borrowings, with billions of dollars of scarce capital tied up, and millions more often spent by the companies in the heat of battle.
>
> o Plant Closings. Second, takeovers sometimes result in plant closings, or consolidations of plants, with a resulting loss of jobs and a community's health and revenue base.
>
> o Jobs and Commitments to Employees. In addition to jobs actually lost through plant closings or consolidation, the winner in a takeover battle inevitably engages in wholesale restructuring of the combined businesses. As a result, even as to jobs not totally eliminated, the functions and responsibilities of the targets' employees who remain substantially change from those they performed prior to the takeover. Thus, in a very real sense, hostile takeovers also threaten the quality of employment; expectations of long-term employees that have been committed and nurtured by the target are simply cast aside.

- o Local Government--Tax Base. Of course, if plants are closed, and jobs lost, as a result of hostile takeovers, another constituency that suffers is government. The tax base shrinks--not only in terms of property taxes, but income and sales or any other taxes contingent upon people earning and spending money. At the same time, the demands on government resources increase--as for unemployment compensation.

- o Customer/Supplier Relationships. The success of many companies, and thus the jobs that they provide, are often contingent upon long-standing customer/supplier relationship, both nationally and within communities. Such relationships, nurtured over many years, provide a stability to the job climate which a hostile takeover could well destroy.

There are a number of steps that should be taken to protect those who most directly suffer the injuries that follow many of the takeovers.

"Free ride" speculation should be stopped. Therefore, offers to buy a controlling interest in a firm, subject to obtaining financing to pay for it later, should be prohibited.

Possible takeover candidates should have some advance notice and advance information about takeover plans. Therefore, any corporate entity or individual that acquires at least 5 percent of the stock of a company that might become a takeover victim should be required to file with the SEC and publish an economic impact statement, stating explicitly its plans for continuation of the business operation, or for changes or discontinuation of all or parts of the business operation. All takeover offers should have to be open for at least 60 days to give stockholders adequate time to make up their minds about whether or not to accept the offer, and there should be a prohibition against two-tier tender offers.

In addition, there should be enactment of a federal requirement that the state and local governments and workers, including the union where there is one,

must be given six months advance notice of any contemplated closure or discontinuance of a business operation employing 100 or more people. The owners of the business must be required to work with the representatives of the community and the employees to see what disposition could be arranged to maintain employment as far as possible under another ownership.

There is also a need to set up a reserve or an insurance fund to provide for temporary compensation during an adjustment period to the community and to employees where a business operation employing 100 or more employees is being discontinued. Such a fund would have the best chance of being successful if it is operated at a national level so that funds could be accumulated in a large amount to meet the adjustment requirements when plant closures take place. The insurance fee could be quite small, equal to perhaps a fraction of 1 percent of total business volume, to be paid by all businesses having 100 or more employees.

The AFL-CIO favors a broad array of government actions to limit corporate power, to direct credit to productive uses and to protect workers and consumers. Given this Administration's unthinking allegiance to deregulation and its blind faith in "free markets" we recognize that our proposals in this regard are unlikely to be enacted into law quickly enough to meet the current threat. But this much is clear: there is no reason for federal law to encourage the dangerous speculative excesses that feed the takeover epidemic. The AFL-CIO therefore calls for the following immediate actions:

* The tax laws should be changed to prevent the encouragement of takeovers through manipulation of various provisions that result in subsidizing corporate mergers and takeovers. These provisions include capital gains, depreciation, loss carryovers, and interest deductions.

* The practice of "greenmail" -- which is nothing more than extortion by raiders -- should be proscribed. The AFL-CIO favors enactment of proposed

legislation that would prohibit payers of "greenmail" from deducting it as business expense; require recipients of "greenmail" profits to pay taxes on them as ordinary income instead of capital gains. We also favor provisions of the same legislative proposal that would deny the deduction of interest paid on junk bonds whose proceeds are used for a takeover.

* The securities laws should be strengthened in two respects. First, stockholders' rights should be enhanced. Stockholders of firms controlled by would-be corporate raiders should have the right to decide whether to divert their company's assets to finance a raid. Stockholders of a target company, in turn, should have the right to decide whether to expend their company's assets on defensive measures against a raid. Most important, when a raid is launched, stockholders of the target company should also have the right to decide democratically, free of pressures of two-tiered tender offers and the like, whether to accept or reject the tender offer. Second, the threshold at which a person must report beneficial ownership in a public company should be reduced in order to promote full disclosure of takeover efforts.

* The laws regulating banks, trustees and other fiduciaries should prohibit investment in the unsound, speculative instruments of the corporate raider.

* Finally, mechanisms must be developed which protect the interests of workers and communities in mergers and takeovers.

We believe action by Congress is essential to protect these interests and to protect the economic and social health of the nation.

National Council of
Savings Institutions
James J. Butera
Group Vice President for
Legislative and Regulatory Policy

July 9, 1985

The Honorable Alfonse D'Amato
Chairman
Securities Subcommittee of the
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

The National Council of Savings Institutions, on behalf of its 600 savings bank and savings and loan members, is pleased to submit these views on pending legislative proposals (S. 975, S. 1016 and S. 1286) to curtail the use of certain types of debt instruments, known variously as "high yield", "growth" or "junk" bonds. These legislative proposals, which would also limit the authority of federally insured depository institutions to invest in "noninvestment grade securities," were reviewed by the National Council's Committee on Asset and Liability Management at its May 1985 meeting. It was the unanimous view of the savings industry executives serving on that Committee that the enactment of legislation in this area is neither neceesary nor justified at this time.

Like many emerging and innovative corporate finance activities, high yield bonds are not appropriate for every institution's portfolio. The higher yields must be weighed against the prospect of additional losses, the consequences of reduced liquidity and the additional managerial time required to monitor the market. However, evaluations of this type represent the very essence of managing financial institutions, and should therefore be viewed as the proper function of private sector judgments rather than governmental action. Since the proponents of the pending bills have not been able to demonstrate that the default ratio on noninvestment grade securities is substantially different than that of bonds carrying higher ratings, we see no reason to preempt the workings of the financial markets.

Even if the case could be made that investment in high yield bonds issued in connection with corporate acquisitions constitute a threat to the safety and soundness of insured institutions, we believe it critical that Congress recognize that there are numerous other uses of noninvestment grade securities. In fact, most noninvestment grade or unrated bonds have nothing to do with takeover financing, but are issued by companies which have an insufficient operating history to command an investment quality rating from Moody's, Standards and Poors, or the other principal rating agencies. Another major category of issuers are those companies which have had credit problems that resulted in rating downgradings (steel, certain utilities, etc.).

Recently, the National Council conducted a special survey of our members on this subject and the results indicate that approximately 35 per cent of the nation's approximately 400 savings banks hold nonrated securities in their portfolios. A lower but still substantial 6 per cent of savings and loan associations responding to the survey also indicated investments of this type. The important point turned up by our survey is that over 98 per cent of the holdings of nonrated securities by savings institutions are bonds which are not related to financing corporate acquisitions.

This is significant because as we interpret the language of the pending bills, all holdings of below investment grade and unrated bonds would be prohibited. This would accomplish nothing by way of promoting safety and soundness and would cover many situations where savings banks and savings and loan associations have invested in local companies, both public and private, as a means of supporting their local economies. These investments, which run in the billions of dollars, would be banned under the terms of all the pending bills. We respectfully suggest that this result, while perhaps unintended, nevertheless points up the extreme difficulty of drafting statutory language to control market developments which are subject to innumerable variations and frequent innovations.

While the pending bills contemplate a prospective ban, thereby avoiding problems relating to divestiture, this should not be viewed as eliminating the adverse impact of such a step on institutions holding noninvestment grade securities. Legislation prohibiting thousands of present and potential market participants from purchasing these types of debt instruments will severely curtail the marketability of the bonds, not to mention the actual value of the assets now held in portfolio.

As an alternative, we would suggest that, to the extent the Congress has identified a problem in this area, it would be much better to address it through a general directive to the federal financial supervisory agencies to handle the matter by administrative rulemaking. The Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board could readily fashion regulations that are more limited and flexible than an outright statutory ban. In fact, the FHLBB has already proposed regulations circumscribing investments of this type by institutions under its jurisdiction to ensure that they are sufficiently diversified and subject to a number of other prudential criteria.

Thank you very much for taking these views into consideration; we request that this letter be made a part of the formal hearing record.

Sincerely yours,

James J. Butera
Group Vice President

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September 27, 1985

The Honorable Alfonse M. D'Amato
United States Senate
520 Hart Senate Office Building
Washington, D.C. 20515

Dear Senator D'Amato:

You will perhaps recall that, when I testified before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee on June 6, 1985, you asked that I submit suggestions with regard to how the Securities and Exchange Commission might go about tightening enforcement of its existing disclosure requirements.

Because I referred in my testimony to two separate and distinct disclosure provisions, I would prefer to discuss them separately. The Schedule 13D requirement is, as you know, triggered when an investor passes the 5% threshold of stock ownership. At that time, the investor is required to make his ownership known and to publicly declare his intentions towards the company whose stock he is acquiring. But investors typically say they have no "present intention" to acquire a controlling interest in the company (and indeed the contrary answer would generally trigger the Hart-Scott-Rodino filing requirements, with its attendant waiting period). In most cases, no one takes this disclaimer of any "present intention" very seriously because experience demonstrates that, when it serves the investor's interest to do so, he will announce that he has changed his mind.

It can, of course, be argued that, if no one is misled, no harm is done. But that is not the point. The securities laws were not put in place to encourage charades. The SEC staff complains that they are handcuffed because they cannot get inside the investor's mind to prove when his intent changed (if indeed it ever really did). The solution, as I suggested in the prepared text of my testimony, would appear to lie in the creation of a presumption. The investor would be presumed to have misrepresented his true intention if he subsequently acquired more than an additional 5% of the company stock within six months of purchasing the initial 5%

block. Of course, he would be free to rebut the presumption, but, should he fail to do so, some meaningful sanction would be imposed. For example, he could be deprived of the right to vote the stock for a period of six months to a year.

I also discussed in my testimony the Schedule 14D tender offer filing, where the proposed acquirer typically states that he has no "present plans or proposals" to sell or transfer a material amount of the assets of the subject company. To my mind, this is a significantly more serious loophole than the 5% threshold filing mandated by Schedule 13D because shareholders -- who may also be employees, customers, or suppliers of the subject company -- have little choice but to rely on what is in the Schedule 14D materials in deciding whether to tender their shares.

The SEC staff takes the position that, because the proposed acquirer is ordinarily relying only on published financial statements and other public data at the time he files his Schedule 14D, he should not be held to the contents of that disclosure statement if his tender offer succeeds and he subsequently obtains access to the corporation's internal books and records. But it seems incongruous, if not ludicrous, to suggest that a sophisticated investor is going to put millions, if not billions, of dollars on the line to acquire control of a company without having a good idea of what he intends to do with it. In any event, a balancing of the equities leads one to conclude that, if anyone is to be at risk, it should be the proposed acquirer rather than the shareholders whom he is asking to tender their stock.

If the SEC wanted to put some teeth in the Schedule 14D disclosure provision, it could do so by rule providing that, except as disclosed in the tender offer document, no assets of the acquired company could be sold or transferred for a period of one year following the completion of the tender offer. The rule would not apply provided the former owners whose shares had been purchased received the difference between (a) the market price of each share following the sale plus the per share amount realized by the asset sale, minus (b) the price the acquirer had paid for the tendered shares. This approach would serve both to encourage disclosure of the acquirer's true intent as well as to insure that the pre-tender shareholders would reap the benefits of any immediate asset divestiture which was not disclosed.

I put forward these solutions with the full realization that the SEC, were it so inclined, could devise better ones. The problem seems to be that the SEC is more interested in telling us why it is difficult to enforce existing regulations than it is in proposing new ones that could not be so easily subverted. It seems to me that the latter is the mission and responsibility of the SEC, and it is those new solutions that my testimony was intended to evoke.

Very truly yours,

John A. Georges

John A. Georges